

1988

AICPA Professional Standards: U.S. Auditing Standards as of June 1, 1988

American Institute of Certified Public Accountants

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AICPA PROFESSIONAL STANDARDS

Volume 1

U.S. Auditing Standards

As of June 1, 1988

AICPA

American Institute of Certified Public Accountants

AICPA PROFESSIONAL STANDARDS

Volume 1

U.S. Auditing Standards

<p>SEE NOTICE TO READERS ON PAGES iii—iv BEFORE USING THIS VOLUME.</p>

As of June 1, 1988

AICPA

American Institute of Certified Public Accountants

Published for the
American Institute of
Certified Public Accountants
by

COMMERCE CLEARING HOUSE, INC.
4025 W. Peterson Ave.
Chicago, Illinois 60646

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1211 AVENUE OF THE AMERICAS, NEW YORK, NEW YORK 10036

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NOTICE TO READERS

This June 1, 1988, edition of AICPA **Professional Standards**, volume 1, includes the appropriate AU sections for Statements on Auditing Standards (SAS) Numbers 53 through 61 issued in April 1988, which have the following effective dates:

- Effective for audits of financial statements for periods beginning after January 1, 1989
 - SAS No. 53 *The Auditor's Responsibility to Detect and Report Errors and Irregularities*
 - SAS No. 54 *Illegal Acts By Clients*
 - SAS No. 56 *Analytical Procedures*
 - SAS No. 57 *Auditing Accounting Estimates*
 - SAS No. 59 *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
 - SAS No. 60 *Communication of Internal Control Structure Related Matters Noted in an Audit*
 - SAS No. 61 *Communication With Audit Committees*
- Effective for reports issued or reissued on or after January 1, 1989
 - SAS No. 58 *Reports on Audited Financial Statements*
- Effective for audits of financial statements for periods beginning on or after January 1, 1990
 - SAS No. 55 *Consideration of the Internal Control Structure in a Financial Statement Audit*

Since these SASs all have effective dates of 1989 or 1990, but permit early application, the superseded AU sections are included in Appendix G of this edition of **Professional Standards**. The superseded AU sections, which can be found in Appendix G, are:

- AU Section 318 *Analytical Review Procedures*
- AU Section 320 *The Auditor's Study and Evaluation of Internal Control*
- AU Section 323 *Required Communication of Material Weaknesses in Internal Accounting Control*
- AU Section 327 *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*
- AU Section 328 *Illegal Acts by Clients*
- AU Section 340 *The Auditor's Consideration When a Question Arises About an Entity's Continued Existence*
- AU Section 505 *Reports on Comparative Financial Statements*
- AU Section 509 *Reports on Audited Financial Statements*

Notice to Readers

- AU Section 542 *Other Conditions Which Preclude the Application of Necessary Auditing Procedures*
- AU Section 545 *Inadequate Disclosure*
- AU Section 546 *Reporting on Inconsistency*
- AU Section 642 *Reporting on Internal Accounting Control, paragraphs .47 through .53*

SAS Nos. 53 through 61 also introduce auditing standards terminology, concepts and procedures that affect, and may require conforming changes to, other AU sections not superseded by the SASs listed above. The Auditing Standards Board expects to complete later in 1988 a review of **Professional Standards**, volume 1, to determine the nature and extent of the conforming changes required. The affected section will then be updated in the looseleaf edition of **Professional Standards** and in the next edition of the **Codification of Statements on Auditing Standards** to reflect those conforming changes. Users of this edition of **Professional Standards** should be aware that there may be some inconsistencies between the sections which contain the new SASs and other sections.

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HOW TO USE VOLUME 1

Scope of Volume 1...

This volume, which is a reprint of volume 1 of the looseleaf edition of *AICPA Professional Standards*, includes the currently effective pronouncements on professional standards issued by the American Institute of Certified Public Accountants (AICPA).

How This Volume Is Arranged...

The contents of this volume are arranged as follows:

Statements on Auditing Standards

Introduction

The General Standards

The Standards of Field Work

The First, Second, and Third Standards of Reporting

The Fourth Standard of Reporting

Other Types of Reports

Special Topics

Special Reports of the Committee on Auditing Procedure

Statements on Standards for Attestation Engagements

Statements on Standards for Attestation Engagements

Statement on Standards for Accountants' Services on Prospective Financial Information

Prospective Financial Information

Auditing Interpretations

How to Use This Volume...

The arrangement of material is indicated in the general table of contents at the front of the volume. There is a detailed table of contents covering the material within each major division.

AUDITING (UNITED STATES)

The major divisions are divided into sections, each with its own section number. Each paragraph within a section is decimally numbered.

For example, AU section 210.04 refers to the fourth paragraph of section 210, *Training and Proficiency of the Independent Auditor*.

Auditing Interpretations are numbered in the 9000 series with the last three digits indicating the section to which the Interpretation relates. For example, Interpretations related to section 311 are numbered 9311.

There are seven appendixes related to auditing standards as follows:

Appendix A provides the historical background for the present Statements on Auditing Standards.

Appendix B is a list of Statements on Auditing Procedure Nos. 1-54, Statements on Auditing Standards, Statements on Standards for Attestation Engagements, and Statement on Standards for Accountants' Services on Prospective Financial Information issued to date.

Appendix C provides a list of sources of sections in the current text.

Appendix D indicates sections and paragraphs of the text cross-referenced to Auditing Interpretations.

Appendix E provides a list of AICPA Audit and Accounting Guides and Statements of Position.

Appendix F provides a schedule of changes in Statements on Auditing Standards since the issuance of Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures, Nos. 33 through 54*.

Appendix G includes AU sections superseded by the issuance of Statements on Auditing Standards Numbers 53 through 61.

A topical index is provided for the Auditing division, and is identified as AU Topical Index.

Topical Index...

The topical index uses the key word method to facilitate reference to the pronouncements. The index is arranged alphabetically by topic and refers the reader to major divisions, sections, and paragraph numbers.

Master Topical Index...

The Master Topical Index, appearing on the following pages, includes the major headings from each one of the indexes in *AICPA Professional Standards*. The letter citations refer the reader to the index in which the major headings are used.

Indexes are cited in the volumes as follows:

	Citation
Auditing (United States)	AU
Accounting and Review Services	AR
Code of Professional Conduct	ET
Bylaws	BL
Accounting (International)	AC
Auditing (International)	AU
Management Advisory Services	MS
Tax Practice	TX

A search for information by subject heading may begin either (1) at the level of the Master Topical Index to identify the individual indexes which contain detailed entries on the subject or (2) at the level of the detailed topical index related to the subject.

Reference Abbreviations...

References to *AICPA Professional Standards* use the same citations as listed in the Master Topical Index.

The abbreviation AC, excluding the AC 9000 series which refer to International Accounting Standards, is used to indicate references to the *Accounting Standards—Current Text* published by the Financial Accounting Standards Board. The *Current Text* contains an abridged version of the currently effective financial and reporting standards as amended to date. Quotations of accounting standards in this volume are derived from the original pronouncements and may have been editorially changed in the *Current Text*.

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AU Section 100

STATEMENTS ON AUDITING STANDARDS – Introduction

Statements on Auditing Standards are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Ethics requires adherence to the applicable generally accepted auditing standards promulgated by the Institute. It recognizes Statements on Auditing Standards as interpretations of generally accepted auditing standards and requires that members be prepared to justify departures from such Statements.

... responsibilities and functions of independent auditor ... generally accepted auditing standards ... quality control standards ...

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161 The Relationship of Generally Accepted Auditing Standards to Quality Control Standards01-.03

➡ The next page is 61. ⬅

AU Section 110***Responsibilities and Functions
of the Independent Auditor***

Source: SAS No. 1, section 110.

Issue date, unless otherwise indicated: November, 1972.

.01 The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his examination has been made in accordance with generally accepted auditing standards. These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles and whether such principles have been consistently applied in the preparation of the financial statements of the current period in relation to those of the preceding period.

Distinction Between Responsibilities of Auditor and Management

.02 Management has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements. The transactions which should be reflected in the accounts and in the financial statements are matters within the direct knowledge and control of management. The auditor's knowledge of such transactions is limited to that acquired through his examination. Accordingly, the fairness of the representations made through financial statements is an implicit and integral part of management's responsibility. The independent auditor may make suggestions as to the form or content of financial statements or he may draft them in whole or in part, based on management's accounts and records. However, his responsibility for the statements he has examined is confined to the expression of his opinion on them. The financial statements remain the representations of management.

Professional Qualifications

.03 The professional qualifications required of the independent auditor are those of a person with the education and experience to practice as such. They do not include those of a person trained for or qualified to engage in another profession or occupation. For example, the independent auditor, in observing the taking of a physical inventory, does not purport to act as an appraiser, a valuer, or an expert in materials. Similarly, although the independent auditor is informed in a general manner about matters of commercial law, he does not purport to act in the capacity of a lawyer and may appropriately rely upon the advice of attorneys in all matters of law.

.04 In the observance of generally accepted auditing standards, the independent auditor must exercise his judgment in determining which auditing procedures are necessary in the circumstances to afford a reasonable basis for his opinion. His judgment is required to be the informed judgment of a qualified professional person.

Detection of Fraud

[.05—.08] [Superseded January 1977 by Statement on Auditing Standards No. 16.] (See section 327 in Appendix G.)

Responsibility to the Profession

.09 The independent auditor also has a responsibility to his profession, the responsibility to comply with the standards accepted by his fellow practitioners. In recognition of the importance of such compliance, the American Institute of Certified Public Accountants has adopted, as part of its Code of Professional Ethics, rules which support the standards and provide a basis for their enforcement.

[The next page is 81.]

AU Section 150

Generally Accepted Auditing Standards

Sources: SAS No. 1, section 150; SAS No. 43.

Issue date, unless otherwise indicated: November, 1972.

.01 Auditing standards differ from auditing procedures in that "procedures" relate to acts to be performed, whereas "standards" deal with measures of the quality of the performance of those acts and the objectives to be attained by the use of the procedures undertaken. *Auditing standards* as distinct from *auditing procedures* concern themselves not only with the auditor's professional qualities but also with the judgment exercised by him in the performance of his examination and in his report.

.02 The generally accepted auditing standards as approved and adopted by the membership of the American Institute of Certified Public Accountants are as follows:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

.03 These standards to a great extent are interrelated and interdependent. Moreover, the circumstances which are germane to a determination of whether one standard is met may apply equally to another. The elements of "materiality" and "relative risk" underlie the application of all the standards, particularly the standards of field work and reporting.

.04 The concept of materiality is inherent in the work of the independent auditor.* There should be stronger grounds to sustain the independent auditor's opinion with respect to those items which are relatively more important and with respect to those in which the possibilities of material error are greater than with respect to those of lesser importance or those in which the possibility of material error is remote. For example, in an entity with few, but large, accounts receivable, the accounts individually are more important and the possibility of material error is greater than in another entity that has a great number of small accounts aggregating the same total. In industrial and merchandising enterprises, inventories are usually of great importance to both financial position and results of operations and accordingly may require relatively more attention by the auditor than would the inventories of a public utility company. Similarly, accounts receivable usually will receive more attention than prepaid insurance.

.05 The degree of risk involved also has an important bearing on the nature of the examination.* Cash transactions are more susceptible to irregularities than inventories, and the work undertaken on cash may therefore have to be carried out in a more conclusive manner without necessarily implying a greater expenditure of time. Arm's-length transactions with outside parties are usually subjected to less detailed scrutiny than intercompany transactions or transactions with officers and employees, where the same degree of disinterested dealing cannot be assumed. The effect of internal control on the scope of an examination is an outstanding example of the influence on auditing procedures of a greater or lesser degree of risk of error; i.e., the stronger the internal control, the less the degree of risk.

Services Other Than Examinations of Financial Statements

.06 In addition to examinations of financial statements, the ten generally accepted auditing standards, to the extent that they are relevant in the circumstances, apply to all other services governed by Statements on Auditing Standards unless the Statement specifies otherwise. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

[The next page is 97.]

* Editor's Note: See section 312, *Audit Risk and Materiality in Conducting an Audit*.

AU Section 161***The Relationship of Generally Accepted Auditing Standards to Quality Control Standards***

(Supersedes Statement on Auditing Standards

No. 4, *Quality Control Considerations for a Firm of Independent Auditors*)¹

Source: SAS No. 25.

Issue date, unless otherwise indicated: November, 1979.

.01 The independent auditor is responsible for compliance with generally accepted auditing standards in an audit engagement. Rule 202 [ET section 202.01] of the Rules of Conduct of the Code of Professional Ethics of the American Institute of Certified Public Accountants requires members to comply with such standards when associated with financial statements.

.02 A firm of independent auditors also needs to comply with generally accepted auditing standards in conducting an audit practice. Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance of conforming with generally accepted auditing standards in its audit engagements. The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.

.03 Generally accepted auditing standards relate to the conduct of individual audit engagements; quality control standards relate to the conduct of a firm's audit practice as a whole. Thus, generally accepted auditing standards and quality control standards are related, and the quality control policies and procedures that a firm adopts may affect both the conduct of individual audit engagements and the conduct of a firm's audit practice as a whole.

¹ The elements of quality control identified in SAS No. 4 have been incorporated in the body of Statement on Quality Control Standards 1, [QC section 10], *System of Quality Control for a CPA Firm*, issued by the AICPA Quality Control Standards Committee—the senior technical committee of the Institute designated to issue pronouncements on quality control standards.

AU Section 200

THE GENERAL STANDARDS

. . . nature of standards . . . training and
proficiency of auditor . . . independence . . .
performance of work . . .

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AU Section 201***Nature of the General Standards***

Source: SAS No. 1, section 201.

Issue date, unless otherwise indicated: November, 1972.

.01 The general standards are personal in nature and are concerned with the qualifications of the auditor and the quality of his work as distinct from those standards which relate to the performance of his field work and to his reporting. These personal, or general, standards apply alike to the areas of field work and reporting.

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AU Section 210***Training and Proficiency
of the Independent
Auditor***

Sources: SAS No. 1, section 210; SAS No. 5.

Issue date, unless otherwise indicated: November, 1972.

.01 The first general standard is:

The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

.02 This standard recognizes that however capable a person may be in other fields, including business and finance, he cannot meet the requirements of the auditing standards without proper education and experience in the field of auditing.

.03 In the performance of the examination which leads to an opinion, the independent auditor holds himself out as one who is proficient in accounting and auditing. The attainment of that proficiency begins with the auditor's formal education and extends into his subsequent experience. The independent auditor must undergo training adequate to meet the requirements of a professional. This training must be adequate in technical scope and should include a commensurate measure of general education. The junior assistant, just entering upon an auditing career, must obtain his professional experience with the proper supervision and review of his work by a more experienced superior. The nature and extent of supervision and review must necessarily reflect wide variances in practice. The auditor charged with final responsibility for the engagement must exercise a seasoned judgment in the varying degrees of his supervision and review of the work done and judgment exercised by his subordinates, who in turn must meet the responsibility attaching to the varying gradations and functions of their work.

.04 The independent auditor's formal education and professional experience complement one another; each auditor exercising authority upon an engagement should weigh these attributes in determining the extent of his supervision of subordinates and review of their work. It should be recognized that the training of a professional man includes a continual awareness of developments taking place in business and in his profession. He must study, understand, and apply new pronouncements on accounting principles and auditing procedures as they are developed by authoritative bodies within the accounting profession.

.05 In the course of his day-to-day practice, the independent auditor encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to examine and report upon the financial statements of a business because, through his training and experience, he has become skilled in accounting and auditing and has acquired the ability to consider objectively and to exercise independent judgment with respect to the information recorded in books of account or otherwise disclosed by his examination. [As amended July, 1975 by Statement on Auditing Standards No. 5.] (See section 411.)

[The next page is 161.]

AU Section 220

Independence

Source: SAS No. 1, section 220.

Issue date, unless otherwise indicated: November, 1972.

.01 The second general standard is:

In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

.02 This standard requires that the auditor be independent; aside from being in public practice (as distinct from being in private practice), he must be without bias with respect to the client since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be. However, independence does not imply the attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors.

.03 It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To be independent, the auditor must be intellectually honest; to be *recognized* as independent, he must be free from any obligation to or interest in the client, its management, or its owners. For example, an independent auditor auditing a company of which he was also a director might be intellectually honest, but it is unlikely that the public would accept him as independent since he would be in effect auditing decisions which he had a part in making. Likewise, an auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased. Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.

.04 The profession has established, through the Institute's Code of Professional Ethics, precepts to guard against the *presumption* of loss of independence. "Presumption" is stressed because the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests. Insofar as these precepts have been incorporated in the profession's code of ethics, they have the force of professional law for the independent auditor.

.05 The Securities and Exchange Commission has also adopted requirements for independence of auditors who report on financial statements filed with it that differ from the AICPA requirements in certain respects. [As modified, November 1979, by the Auditing Standards Board.]

.06 The independent auditor should administer his practice within the spirit of these precepts and rules if he is to achieve a proper degree of independence in the conduct of his work.

.07 To emphasize independence from management, many corporations follow the practice of having the independent auditor appointed by the board of directors or elected by the stockholders.

[The next page is 171.]

AU Section 230***Due Care in the
Performance
of Work***

Sources: SAS No. 1, section 230; SAS No. 41.

Issue date, unless otherwise indicated: November, 1972.

.01 The third general standard is:

Due professional care is to be exercised in the performance of the examination and the preparation of the report.

.02 This standard requires the independent auditor to perform his work with due care. Due care imposes a responsibility upon each person within an independent auditor's organization to observe the standards of field work and reporting. Exercise of due care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the examination.

.03 A paragraph appearing in *Cooley On Torts* often cited by attorneys in discussing due care merits quotation here:

Every man who offers his service to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is prerequisite, if one offers his service, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and, if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error. He undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.

.04 The matter of due care concerns what the independent auditor does and how well he does it. [As amended, April 1982, by Statement on Auditing Standards No. 41.] (See section 339.)

AU Section 300

THE STANDARDS OF FIELD WORK

... auditor's appointment and planning ... planning and supervision ... audit risk and materiality ... predecessor and successor auditors ... analytical procedures ... internal control ... substantive tests prior to balance-sheet date ... effect of internal audit function on scope of examination ... communication of internal control structure ... special-purpose reports on internal accounting control at service organizations ... evidential matter ... errors and irregularities ... illegal acts by clients ... receivables and inventories ... long-term investments ... client representations ... related parties ... using work of specialist ... inquiry of client's lawyer ... working papers ... entity's continued existence ... auditing accounting estimates ... communication with audit committees ... audit sampling ...

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AU Section 310

Relationship Between the Auditor's Appointment and Planning*

Sources: SAS No. 1, section 310; SAS No. 45.

Issue date, unless otherwise indicated: November, 1972.

.01 The first standard of field work is:

The work is to be adequately planned and assistants, if any, are to be properly supervised.

.02 Aspects of supervising assistants are discussed in section 210, *Training and Proficiency of the Independent Auditor*, and section 311, *Planning and Supervision*. Aspects of planning the field work and the timing of auditing procedures are discussed in section 311 and section 313, *Substantive Tests Prior to the Balance-Sheet Date*. [As amended August 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

Appointment of the Independent Auditor

.03 Consideration of the first standard of field work recognizes that early appointment of the independent auditor has many advantages to both the auditor and his client. Early appointment enables the auditor to plan his work so that it may be done expeditiously and to determine the extent to which it can be done before the balance-sheet date. [As amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

Appointment of Auditor Near or After The Year-End Date

.04 Although early appointment is preferable, an independent auditor may accept an engagement near or after the close of the fiscal year. In such instances, before accepting the engagement, he should ascertain whether circumstances are likely to permit an adequate examination and expression of an unqualified opinion and, if they will not, he should discuss with the client the possible necessity for a qualified opinion or disclaimer of opinion. Sometimes the audit limitations present in such circumstances can be remedied. For example, the taking of the physical inventory can be postponed or another physical inventory can be taken which the auditor can observe. (See section 331.09—.13.)

Timing of Audit Work

[.05—.09] [Superseded August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

[The next page is 229.]

* [Title amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

AU Section 311

Planning and Supervision

Sources: SAS No. 22; SAS No. 47; SAS No. 48.

See section 9311 for interpretations of this section.

Effective for periods ending after September 30, 1978, unless otherwise indicated.

.01 The first standard of field work requires that "the work is to be adequately planned and assistants, if any, are to be properly supervised." This section provides guidance to the independent auditor making an examination in accordance with generally accepted auditing standards on the considerations and procedures applicable to planning and supervision, including preparing an audit program, obtaining knowledge of the entity's business, and dealing with differences of opinion among firm personnel. Planning and supervision continue throughout the examination, and the related procedures frequently overlap.

.02 The auditor with final responsibility for the examination may delegate portions of the planning and supervision of the examination to other firm personnel. For purposes of this section, (a) firm personnel other than the auditor with final responsibility for the examination are referred to as *assistants* and (b) the term *auditor* refers to either the auditor with final responsibility for the examination or assistants.

Planning

.03 Audit planning involves developing an overall strategy for the expected conduct and scope of the examination. The nature, extent, and timing of planning vary with the size and complexity of the entity, experience with the entity, and knowledge of the entity's business. In planning the examination, the auditor should consider, among other matters:

- a. Matters relating to the entity's business and the industry in which it operates (see paragraph .07).
- b. The entity's accounting policies and procedures.
- c. The methods used by the entity to process significant accounting information (see paragraph .09), including the use of service organizations, such as outside service centers.
- d. Anticipated reliance on internal accounting controls. (See section 320.51 through .55 in Appendix G.)
- e. Preliminary judgment about materiality levels for audit purposes.
- f. Financial statement items likely to require adjustment.
- g. Conditions that may require extension or modification of audit tests, such as the possibility of material errors or irregularities or the existence of related party transactions.

- h. The nature of reports expected to be rendered (for example, a report on consolidated or consolidating financial statements, reports on financial statements filed with the SEC, or special reports such as those on compliance with contractual provisions).

[As amended, December, 1983, by Statement on Auditing Standards No. 47.]
(See section 312.10.) [As amended, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.04 Procedures that an auditor may consider in planning the examination usually involve review of his records relating to the entity and discussion with other firm personnel and personnel of the entity. Examples of those procedures include:

- a. Reviewing correspondence files, prior year's working papers, permanent files, financial statements, and auditor's reports.
- b. Discussing matters that may affect the examination with firm personnel responsible for non-audit services to the entity.
- c. Inquiring about current business developments affecting the entity.
- d. Reading the current year's interim financial statements.
- e. Discussing the type, scope, and timing of the examination with management of the entity, the board of directors, or its audit committee.
- f. Considering the effects of applicable accounting and auditing pronouncements, particularly new ones.
- g. Coordinating the assistance of entity personnel in data preparation.
- h. Determining the extent of involvement, if any, of consultants, specialists, and internal auditors.
- i. Establishing the timing of the audit work.
- j. Establishing and coordinating staffing requirements.

The auditor may wish to prepare a memorandum setting forth the preliminary audit plan, particularly for large and complex entities.

.05 In planning his examination, the auditor should consider the nature, extent, and timing of work to be performed and should prepare a written audit program (or a set of written audit programs). An audit program aids in instructing assistants in the work to be done. It should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the examination. The form of the audit program and the extent of its detail will vary. In developing the program, the auditor should be guided by the results of his planning considerations and procedures. As the examination progresses, changed conditions may make it necessary to modify planned audit procedures.

.06 The auditor should obtain a level of knowledge of the entity's business that will enable him to plan and perform his examination in accordance with generally accepted auditing standards. That level of knowledge should enable him to obtain an understanding of the events, transactions, and practices that, in his judgment, may have a significant effect on the financial statements. The level of knowledge customarily possessed by management relating to managing the entity's business is substantially greater than that which is obtained by the auditor in performing his examination. Knowledge of the entity's business helps the auditor in:

- a. Identifying areas that may need special consideration.

- b. Assessing conditions under which accounting data are produced, processed, reviewed, and accumulated within the organization.
- c. Evaluating the reasonableness of estimates, such as valuation of inventories, depreciation, allowances for doubtful accounts, and percentage of completion of long-term contracts.
- d. Evaluating the reasonableness of management representations.
- e. Making judgments about the appropriateness of the accounting principles applied and the adequacy of disclosures.¹

.07 The auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics. Such matters include, for example, the type of business, types of products and services, capital structure, related parties, locations, and production, distribution, and compensation methods. The auditor should also consider matters affecting the industry in which the entity operates, such as economic conditions, government regulations, and changes in technology, as they relate to his examination. Other matters, such as accounting practices common to the industry, competitive conditions, and, if available, financial trends and ratios should also be considered by the auditor.

.08 Knowledge of an entity's business is ordinarily obtained through experience with the entity or its industry and inquiry of personnel of the entity. Working papers from prior years may contain useful information about the nature of the business, organizational structure, operating characteristics, and transactions that may require special consideration. Other sources an auditor may consult include AICPA accounting and audit guides, industry publications, financial statements of other entities in the industry, textbooks, periodicals, and individuals knowledgeable about the industry.

.09 The auditor should consider the methods the entity uses to process accounting information in planning the audit because such methods influence the design of the accounting system and the nature of the internal accounting control procedures. The extent to which computer processing is used in significant accounting applications,² as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures. Accordingly, in evaluating the effect of an entity's computer processing on an examination of financial statements, the auditor should consider matters such as—

- a. The extent to which the computer is used in each significant accounting application.
- b. The complexity of the entity's computer operations, including the use of an outside service center.³
- c. The organizational structure of the computer processing activities.
- d. The availability of data. Documents that are used to enter information into the computer for processing, certain computer files, and other evidential matter that may be required by the auditor may exist only for a short period or only in computer-readable form. In

¹ See sections 411.04 and 411.11. [Reference changed by issuance of Statement on Auditing Standards No. 43.]

² Significant accounting applications are those that relate to accounting information that can materially affect the financial statements the auditor is examining. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

³ See section 324, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, and the related AICPA Audit Guide *Audits of Service-Center-Produced Records* for guidance concerning the use of a service center for computer processing of significant accounting applications. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

some computer systems, input documents may not exist at all because information is directly entered into the system. An entity's data retention policies may require the auditor to request retention of some information for his review or to perform audit procedures at a time when the information is available. In addition, certain information generated by the computer for management's internal purposes may be useful in performing substantive tests (particularly analytical review procedures).⁴

- e. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures.⁵ Using computer-assisted audit techniques may also provide the auditor with an opportunity to apply certain procedures to an entire population of accounts or transactions. In addition, in some accounting systems, it may be difficult or impossible for the auditor to analyze certain data or test specific control procedures without computer assistance.

[New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.10 The auditor should consider whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the flow of transactions, to understand the nature of internal accounting control procedures, or to design and perform audit procedures. If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants.⁶ [New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

Supervision

.11 Supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the examination and determining whether those objectives were accomplished. Elements of supervision include instructing assistants, keeping informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion among firm personnel. The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work. [Formerly paragraph .09, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

⁴ Section 318, *Analytical Review Procedures* (see Appendix G), describes the usefulness of and guidance pertaining to such procedures. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

⁵ See the AICPA Audit and Accounting Guide *Computer-Assisted Audit Techniques* for guidance relating to this specialized area. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

⁶ Since the use of a specialist who is effectively functioning as a member of the audit team is not covered by section 336, *Using the Work of a Specialist*, a computer audit specialist requires the same supervision and review as any assistant. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

.12 Assistants should be informed of their responsibilities and the objectives of the procedures that they are to perform. They should be informed of matters that may affect the nature, extent, and timing of procedures they are to perform, such as the nature of the entity's business as it relates to their assignments and possible accounting and auditing problems. The auditor with final responsibility for the examination should direct assistants to bring to his attention significant accounting and auditing questions raised during the examination so that he may assess their significance. [Formerly paragraph .10, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.13 The work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report. [Formerly paragraph .11, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.14 The auditor with final responsibility for the examination and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the examination. Such procedures should enable an assistant to document his disagreement with the conclusions reached if, after appropriate consultation, he believes it necessary to disassociate himself from the resolution of the matter. In this situation, the basis for the final resolution should also be documented. [Formerly paragraph .12, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Effective Date

.15 Statements on Auditing Standards generally are effective at the time of their issuance. However, since this section provides for practices that may differ in certain respects from practices heretofore considered acceptable, this section will be effective for examinations made in accordance with generally accepted auditing standards for periods ending after September 30, 1978. [Formerly paragraph .13, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

[The next page is 231-7.]

AU Section 312

Audit Risk and Materiality in Conducting an Audit

Source: SAS No. 47.

Effective for examinations of financial statements for periods beginning after June 30, 1984, unless otherwise indicated.

.01 This section provides guidance on the auditor's consideration of audit risk and materiality when planning and performing an examination of financial statements in accordance with generally accepted auditing standards. Audit risk and materiality affect the application of generally accepted auditing standards, especially the standards of field work and reporting, and are implicit in the auditor's standard report. Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

.02 The existence of audit risk is implicit in the phrase "in our opinion." Audit risk¹ is the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated.²

.03 The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles,³ while other matters are not important. The phrase "present fairly in conformity with generally accepted accounting principles" implicitly indicates the auditor's belief that the financial statements taken as a whole are not materially misstated.

.04 Financial statements are materially misstated when they contain errors or irregularities⁴ whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly in conformity with

¹ In addition to audit risk, the auditor is also exposed to loss or injury to his professional practice from litigation, adverse publicity, or other events arising in connection with financial statements that he has examined and reported on. This exposure is present even though the auditor has performed his examination in accordance with generally accepted auditing standards and has reported appropriately on those financial statements. Even if an auditor assesses this exposure as low, he should not perform less extensive procedures than would otherwise be appropriate under generally accepted auditing standards.

² This definition of audit risk does not include the risk that the auditor might erroneously conclude that the financial statements are materially misstated. In such a situation, he would ordinarily reconsider or extend his auditing procedures and request that the client perform specific tasks to reevaluate the appropriateness of the financial statements. These steps would ordinarily lead the auditor to the correct conclusion. This definition also excludes the risk of an inappropriate reporting decision unrelated to the detection and evaluation of errors in the financial statements, such as an inappropriate decision regarding the form of the auditor's opinion because of an uncertainty or limitation on the scope of the audit.

³ The concepts of audit risk and materiality are also applicable to financial statements presented in conformity with a comprehensive basis of accounting other than generally accepted accounting principles; references in this section to financial statements presented in conformity with generally accepted accounting principles also include those presentations.

⁴ Errors and irregularities are defined in section 327, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities* (see Appendix G).

generally accepted accounting principles. Errors or irregularities result from misapplications of generally accepted accounting principles, departures from fact, or omissions of necessary information. For purposes of this section, the term "error" includes all such errors or irregularities.

.05 When reaching a conclusion as to whether the effect of errors, individually or in the aggregate, is material, an auditor ordinarily should consider their nature and amount in relation to the nature and amount of items in the financial statements under examination. For example, an amount that is material to the financial statements of one entity may not be material to the financial statements of another entity of a different size or nature. Also, what is material to the financial statements of a particular entity might change from one period to another.

.06 The auditor's consideration of materiality is a matter of professional judgment and is influenced by his perception of the needs of a reasonable person who will rely on the financial statements. The perceived needs of a reasonable person are recognized in the discussion of materiality in Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, which defines materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." That discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

.07 As a result of the interaction of quantitative and qualitative considerations in materiality judgments, errors of relatively small amounts detected by the auditor could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

Planning the Audit

.08 The auditor should consider audit risk and materiality both in (a) planning the audit and designing auditing procedures and (b) evaluating whether the financial statements taken as a whole are presented fairly in conformity with generally accepted accounting principles. The auditor should consider audit risk and materiality in the first circumstance to obtain sufficient competent evidential matter on which to properly evaluate the financial statements in the second circumstance.

Considerations at the Financial Statements Level

.09 The auditor should plan the audit so that audit risk will be limited to a low level that is, in his professional judgment, appropriate for issuing an opinion on the financial statements. Audit risk may be assessed in quantitative or nonquantitative terms.

.10 Section 311, *Planning and Supervision*, requires the auditor, in planning the audit, to take into consideration, among other matters, his preliminary judgment about materiality levels for audit purposes.⁵ That judgment may or may not be quantified.

⁵ This section amends section 311, *Planning and Supervision*, paragraph .03e, by substituting the words "Preliminary judgment about materiality levels" in place of the words "Preliminary estimates of materiality levels." [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

.11 According to Section 311, the nature, timing, and extent of planning—and thus of the considerations of audit risk and materiality— vary with the size and complexity of the entity, the auditor's experience with the entity, and his knowledge of the entity's business. Certain entity-related factors also affect the nature, timing, and extent of auditing procedures with respect to specific account balances and classes of transactions. (See paragraphs .17 through .26.)

.12 In planning the audit, the auditor should use his judgment as to the appropriately low level of audit risk and his preliminary judgment about materiality levels in a manner that can be expected to provide him, within the inherent limitations of the auditing process, with sufficient evidential matter to make a reasonable evaluation whether the financial statements are materially misstated. Materiality levels include an overall level for each statement; however, because the statements are interrelated, and for reasons of efficiency, the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of errors that could be considered material to any one of the financial statements. For example, if he believes that errors aggregating approximately \$100,000 would have a material effect on income but that such errors would have to aggregate approximately \$200,000 to materially affect financial position, it would not be appropriate for him to design auditing procedures that would be expected to detect errors only if they aggregate approximately \$200,000.

.13 The auditor generally plans the audit primarily to detect errors that he believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. Although the auditor should be alert for errors that could be qualitatively material, it ordinarily is not practical to design procedures to detect them. Section 326, *Evidential Matter*, states that "an auditor typically works within economic limits; his opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost."

.14 In some situations, the auditor considers materiality for planning purposes before the financial statements to be examined are prepared. In other situations, his planning takes place after the financial statements under examination have been prepared, but he may be aware that they require significant modification. In both types of situations, the auditor's preliminary judgment about materiality might be based on the entity's annualized interim financial statements or financial statements of one or more prior annual periods, as long as he gives recognition to the effects of major changes in the entity's circumstances (for example, a significant merger) and relevant changes in the economy as a whole or the industry in which the entity operates.

.15 Assuming, theoretically, that the auditor's judgment about materiality at the planning stage was based on the same information available to him at the evaluation stage, materiality for planning and evaluation purposes would be the same. However, it ordinarily is not feasible for the auditor, when planning an audit, to anticipate all of the circumstances that may ultimately influence his judgment about materiality in evaluating the audit findings at the completion of the audit. Thus, his preliminary judgment about materiality ordinarily will differ from his judgment about materiality used in evaluating the audit findings. If significantly lower materiality levels become appropriate in evaluating his audit findings, the auditor should reevaluate the sufficiency of the auditing procedures he has performed.

.16 In planning auditing procedures, the auditor should also consider the nature, cause (if known), and amount of errors that he is aware of from the examination of the prior period's financial statements.

Considerations at the Individual Account-Balance or Class-of-Transactions Level

.17 The auditor recognizes that there is an inverse relationship between audit risk and materiality considerations. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low, but the risk that it could be misstated by an extremely small amount might be very high. Holding other planning considerations equal, either a decrease in the level of audit risk that the auditor judges to be appropriate in an account balance or class of transactions or a decrease in the amount of error in the balance or class that he believes could be material would require the auditor to do one or more of the following: (a) select a more effective auditing procedure, (b) perform auditing procedures closer to the balance-sheet date, or (c) increase the extent of a particular auditing procedure.

.18 In determining the nature, timing, and extent of auditing procedures to be applied to a specific account balance or class of transactions,⁶ the auditor should design procedures to detect errors that he believes, based on his preliminary judgment about materiality, could be material, when aggregated with errors in other balances or classes, to the financial statements taken as a whole. Auditors use various methods to design procedures to detect such errors. In some cases, auditors explicitly estimate, for planning purposes, the maximum amount of error in the balance or class that, when combined with errors in other balances or classes, could exist without causing the financial statements to be materially misstated. In other cases, auditors relate their preliminary judgment about materiality to a specific account balance or class of transactions without explicitly estimating such error.

.19 The auditor needs to consider audit risk at the individual account-balance or class-of-transactions level because such consideration directly assists him in determining the scope of auditing procedures for the balance or class. The auditor should seek to restrict audit risk at the individual balance or class level in such a way that will enable him, at the completion of his examination, to express an opinion on the financial statements taken as a whole at an appropriately low level of audit risk. Auditors use various approaches to accomplish that objective.

.20 At the account-balance or class-of-transactions level, audit risk consists of (a) the risk (consisting of inherent risk and control risk) that the balance or class contains error that could be material to the financial statements when aggregated with error in other balances or classes and (b) the risk (detection risk) that the auditor will not detect such error. The discussion that follows describes audit risk in terms of three component risks.⁷ The way the auditor considers these component risks and combines them involves professional judgment and depends on his audit approach.

⁶ For the purpose of this section, the term "account balance or class of transactions" also refers to any component of an account balance or class of transactions or to any related financial statement assertion.

⁷ The formula in the appendix to section 350, *Audit Sampling*, also describes audit risk in terms of three component risks. However, the appendix deals with inherent risk apart from the formula for reasons discussed in footnote 2 [section 350.47] of the appendix, and detection risk is further divided into analytical-review risk and test-of-details risk.

- a. *Inherent risk* is the susceptibility of an account balance or class of transactions to error that could be material, when aggregated with error in other balances or classes, assuming that there were no related internal accounting controls. The risk of such error is greater for some balances or classes than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cash is more susceptible to theft than an inventory of coal. Accounts consisting of amounts derived from accounting estimates pose greater risks than do accounts consisting of relatively routine, factual data. External factors also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. In addition to those factors that are peculiar to a specific account balance or class of transactions, factors that relate to several or all of the balances or classes may influence the inherent risk related to a specific balance or class. These latter factors include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures. (See section 327, *The Independent Auditor's Responsibility for the Detection of Errors and Irregularities*, paragraph .09, in Appendix G.)
- b. *Control risk* is the risk that error that could occur in an account balance or class of transactions and that could be material, when aggregated with error in other balances or classes, will not be prevented or detected on a timely basis by the system of internal accounting control. That risk is a function of the effectiveness of internal accounting control procedures in achieving the broad objectives of internal accounting control. As discussed in section 320.35 (see Appendix G), some control risk will always exist because of the inherent limitations of any system of internal accounting control.
- c. *Detection risk* is the risk that an auditor's procedures will lead him to conclude that error in an account balance or class of transactions that could be material, when aggregated with error in other balances or classes, does not exist when in fact such error does exist. Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or class of transactions and partly because of other uncertainties that exist even if he were to examine 100 percent of the balance or class. Such other uncertainties arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results. These other uncertainties can be reduced to a negligible level through adequate planning and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards.

[Reference number 320.35, formerly 320.34, changed by the issuance of Statement on Auditing Standards No. 48.]

.21 Inherent risk and control risk differ from detection risk in that they exist independently of the audit of financial statements, whereas detection risk relates to the auditor's procedures and can be changed at his discretion. Detection risk should bear an inverse relationship to inherent and control risk. The less the inherent and control risk the auditor believes exists, the greater the detection risk he can accept. Conversely, the greater the inherent and

control risk the auditor believes exists, the less the detection risk he can accept. These components of audit risk may be assessed in quantitative terms such as percentages or in nonquantitative terms that range, for example, from a minimum to a maximum.

.22 When the auditor assesses inherent risk for an account balance or class of transactions, he evaluates numerous factors that involve professional judgments. In doing so, he considers not only factors peculiar to the related balance or class, but also other factors pervasive to the financial statements taken as a whole that may also influence inherent risk related to the balance or class. If an auditor concludes that the effort required to evaluate inherent risk for a balance or class would exceed the potential reduction in the extent of his auditing procedures derived from reliance on the evaluation, he should assess inherent risk as being at the maximum when designing auditing procedures.

.23 The auditor also uses professional judgment in assessing control risk if he studies and evaluates the internal accounting control procedures related to the account balance or class of transactions. In this case, the auditor's assessment of control risk is based on his evaluation of the significance of control weaknesses, if any, related to the balance or class. If the auditor decides that he has no basis to place any reliance on internal accounting controls related to the balance or class, he would assess control risk for that balance or class as being at the maximum.

.24 The auditor might make separate or combined assessments of inherent risk and control risk. If he considers inherent risk or control risk, separately or in combination, to be less than the maximum, he should have an appropriate basis for any reliance he places on his assessments. This basis may be obtained, for example, through the use of questionnaires, checklists, instructions, or similar generalized materials and, in the case of control risk, his study and evaluation of internal accounting controls and his performance of suitable compliance testing. However, professional judgment is required in interpreting, adapting, or expanding such generalized material as appropriate in the circumstances.

.25 The detection risk that the auditor can accept in the design of auditing procedures is based on the level to which he seeks to restrict audit risk related to the account balance or class of transactions and on his assessment of inherent and control risks. As the auditor's assessment of inherent risk and control risk decreases, the detection risk that he can accept increases. It is not appropriate, however, for an auditor to rely completely on his assessments of inherent risk and control risk to the exclusion of performing substantive tests of account balances and classes of transactions where errors could exist that might be material when aggregated with errors in other balances or classes.

.26 An audit of financial statements is a cumulative process; as the auditor performs planned auditing procedures, the evidence he obtains may cause him to modify the nature, timing, and extent of other planned procedures. Information may come to the auditor's attention as a result of performing auditing procedures or from other sources during the audit that differs significantly from the information on which his audit plan was based. For example, the extent of errors he detects may alter his judgment about the levels of inherent and control risks, and other information he obtains about the financial statements may alter his preliminary judgment about materiality. In such cases, he may need to reevaluate the auditing procedures he plans to apply, based on his revised consideration of audit risk and materiality for all or certain of the account balances or classes of transactions.

Evaluating Audit Findings

.27 In evaluating whether the financial statements are presented fairly in conformity with generally accepted accounting principles, the auditor should aggregate errors that the entity has not corrected in a way that enables him to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken

as a whole. Qualitative considerations also influence an auditor in reaching a conclusion as to whether errors are material.

.28 The aggregation of errors should include the auditor's best estimate of the total error in the account balances or classes of transactions that he has examined (hereafter referred to as likely error), not just the amount of errors he specifically identifies (hereafter referred to as known error).⁸ When the auditor tests an account balance or class of transactions by an analytical review procedure, he ordinarily would not specifically identify errors but would only obtain an indication of whether error might exist in the balance or class and possibly its approximate magnitude. If the analytical review procedure indicates that error might exist, but not its approximate amount, the auditor ordinarily would have to employ other procedures to enable him to estimate the likely error in the balance or class. When an auditor uses audit sampling to test an account balance or class of transactions, he projects the amount of known errors he identified in his sample to the items in the balance or class from which his sample was selected. That projected error, along with the results of other substantive tests, contributes to the auditor's assessment of likely error in the balance or class.

.29 The risk of material misstatement of the financial statements is generally greater when account balances and classes of transactions include accounting estimates rather than essentially factual data because of the inherent subjectivity in estimating future events. Estimates, such as those for inventory obsolescence, uncollectible receivables, and warranty obligations, are subject not only to the unpredictability of future events but also to errors that may arise from using inadequate or inappropriate data or misapplying appropriate data. Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely error. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he should treat the difference between that estimate and the closest reasonable estimate as a likely error and aggregate it with other likely errors. The auditor should also consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole.

⁸ If the auditor were to examine all of the items in a balance or class, the likely error applicable to recorded transactions in the balance or class would be the amount of known errors specifically identified.

.30 In prior periods, likely errors may not have been corrected by the entity because they did not cause the financial statements for those periods to be materially misstated. Those errors might also affect the current period's financial statements.⁹ If the auditor believes that there is an unacceptably high risk that the current period's financial statements may be materially misstated when those prior-period likely errors that affect the current period's financial statements are considered along with likely errors arising in the current period, he should include in aggregate likely error the effect on the current period's financial statements of those prior-period likely errors.

.31 If the auditor concludes, based on his accumulation of sufficient evidential matter, that the aggregation of likely errors causes the financial statements to be materially misstated, he should request management to eliminate the material misstatement. If the material misstatement is not eliminated, he should issue a qualified or adverse opinion on the financial statements. Material misstatements may be eliminated by, for example, application of appropriate accounting principles, other adjustments in amounts, or the addition of appropriate disclosure of inadequately disclosed matters. Even though the aggregate effect of likely errors on the financial statements may be immaterial, the auditor should recognize that an accumulation of immaterial errors in the balance sheet could contribute to material misstatements of future financial statements.

.32 If the auditor concludes that the aggregation of likely errors does not cause the financial statements to be materially misstated, he should recognize that they could still be materially misstated due to further error remaining undetected. As aggregate likely error increases, the risk that the financial statements may be materially misstated also increases. Auditors generally reduce this risk of material misstatement in planning the audit by restricting the extent of detection risk they are willing to accept in individual account balances or classes of transactions. Auditors can also reduce this risk of material misstatement by modifying the nature, timing, and extent of planned auditing procedures on a continuous basis in performing the audit. (See paragraph .26.) Nevertheless, if the auditor believes that such risk is unacceptably high, he should perform additional auditing procedures or satisfy himself that the entity has adjusted the financial statements to reduce the risk of material misstatement to an acceptable level.

Effective Date

.33 This section is effective for examinations of financial statements for periods beginning after June 30, 1984.

→ *The next page is 233.* ←

⁹ The measurement of the effect, if any, on the current period's financial statements of errors uncorrected in prior periods involves accounting considerations and is therefore not addressed in this section.

AU Section 313

Substantive Tests Prior to the Balance-Sheet Date

(Supersedes Statement on Auditing Standards

No. 1, AICPA, Professional Standards,

*vol. 1, AU sec. 310.05—.09.) **

Source: SAS No. 45.

Effective for periods ended after September 30, 1983, unless otherwise indicated.

.01 This section provides guidance for audits of financial statements concerning—

- a. Factors to be considered before applying principal substantive tests to the details of particular asset or liability accounts as of a date (*interim date*) that is prior to the balance-sheet date.
- b. Auditing procedures to provide a reasonable basis for extending from an interim date to the balance-sheet date (*remaining period*) the audit conclusions from such principal substantive tests.
- c. Coordinating the timing of auditing procedures.

Guidance concerning the timing of compliance tests is provided in section 320.70 (see Appendix G) (as renumbered by Statement on Auditing Standards No. 43, *Omnibus Statement on Auditing Standards*). [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

.02 Audit testing at interim dates may permit early consideration of significant matters affecting the year-end financial statements (for example, related party transactions, changed conditions, recent accounting pronouncements, and financial statement items likely to require adjustment). In addition, much of the audit planning, the study and evaluation of internal accounting control, and the application of substantive tests to transactions can be conducted prior to the balance-sheet date.¹

* This section amends section 350, *Audit Sampling*, by substituting the term "audit risk" for "ultimate risk," and also amends section 310, by changing the title of that section to *Relationship Between the Auditor's Appointment and Planning*, deleting the last three sentences of section 310.03, and replacing section 310.02 with the following:

Aspects of supervising assistants are discussed in section 210, *Training and Proficiency of the Independent Auditor*, and section 311, *Planning and Supervision*. Aspects of planning the field work and the timing of auditing procedures are discussed in section 311 and section 313, *Substantive Tests Prior to the Balance-Sheet Date*.

Note: In this section, superseding paragraphs are introduced by a dual reference indicating their location in both the individual SASs and AICPA, *Professional Standards*, vol. 1 (COMMERCE CLEARING HOUSE).

¹ Substantive tests such as the following can be applied to transactions through any selected date(s) prior to the balance-sheet date and completed as part of the year-end procedures: (1) tests of details of the additions to and reductions of accounts such as property, investments, and debt and equity capital; (2) tests of details of transactions affecting income and expense accounts; (3) tests of accounts that are not to be audited by testing the details of items composing the balance

.03 Applying principal substantive tests to the details of an asset or liability account as of an interim date rather than as of the balance-sheet date potentially increases the risk that errors that may exist at the balance-sheet date will not be detected by the auditor. The potential for such increased audit risk tends to become greater as the remaining period is lengthened. This potential incremental audit risk can be controlled, however, if the substantive tests to cover the remaining period can be designed in a way that will provide a reasonable basis for extending to the balance-sheet date the audit conclusions from the tests of details at the interim date.

Factors to Be Considered Before Applying Principal Substantive Tests to the Details of Balance-Sheet Accounts at Interim Dates

.04 Before applying principal substantive tests to the details of asset or liability accounts at an interim date, the auditor should assess the difficulty in controlling the incremental audit risk. Paragraphs .05 through .07 discuss considerations that affect that assessment. In addition, the auditor should consider the cost of the substantive tests that are necessary to cover the remaining period in a way that will provide the appropriate audit assurance at the balance-sheet date. Applying principal substantive tests to the details of asset and liability accounts at an interim date may not be cost-effective if substantive tests to cover the remaining period cannot be restricted due to reliance on internal accounting controls.

.05 Reliance on internal accounting controls is not required in order to have a reasonable basis for extending audit conclusions from an interim date to the balance-sheet date; however, if the auditor does not intend to rely on internal accounting controls during the remaining period, he should consider whether the effectiveness of certain of the substantive tests to cover that period will be impaired. For example, suitable controls may be lacking over the internal documents that provide indications of transactions that have been executed. Substantive tests that are based on such documents and relate to the completeness assertion for the remaining period may be ineffective because the documents may be incomplete. Likewise, substantive tests covering the remaining period that relate to the existence assertion at the balance-sheet date may be ineffective if suitable controls over the custody and physical movement of assets are not present. In both of the above examples, if the auditor concludes that the effectiveness of such substantive tests would be impaired, additional assurance should be sought or the accounts should be examined as of the balance-sheet date.

.06 The auditor should consider whether there are rapidly changing business conditions or circumstances that might predispose management to misstate financial statements in the remaining period.² If such conditions or circumstances are present, the auditor might conclude that the substantive tests to cover the remaining period would not be effective in controlling the incremental audit risk associated with them. In those situations, the asset and liability accounts affected should ordinarily be examined as of the balance-sheet date.

(Footnote Continued)

(for example, warranty reserves, clearing accounts, certain deferred charges); and (4) analytical review procedures applied to income and expense accounts.

² See paragraphs .09 and .10 of section 327, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities* in Appendix G.

.07 The auditor should consider whether the year-end balances of the particular asset or liability accounts that might be selected for interim examination are reasonably predictable with respect to amount, relative significance, and composition. He should also consider whether the entity's proposed procedures for analyzing and adjusting such accounts at interim dates and for establishing proper accounting cutoffs are appropriate. In addition, the auditor should consider whether the accounting system will provide information concerning the balances at the balance-sheet date and the transactions in the remaining period that is sufficient to permit investigation of (a) significant unusual transactions or entries (including those at or near year-end); (b) other causes of significant fluctuations, or expected fluctuations that did not occur; and (c) changes in the composition of the account balances. If the auditor concludes that evidential matter related to the above would not be sufficient for purposes of controlling audit risk, the account should be examined as of the balance-sheet date.

Extending Audit Conclusions to the Balance-Sheet Date

.08 Substantive tests should be designed to cover the remaining period in such a way that the assurance from those tests and the substantive tests applied to the details of the balance as of an interim date, and any audit assurance provided from reliance on internal accounting controls, achieve the audit objectives at the balance-sheet date. Such tests ordinarily should include (a) comparison of information concerning the balance at the balance-sheet date with the comparable information at the interim date to identify amounts that appear unusual and investigation of any such amounts and (b) other analytical review procedures or substantive tests of details, or a combination of both, to provide a reasonable basis for extending to the balance-sheet date the audit conclusions relative to the assertions tested directly or indirectly at the interim date.³

.09 If errors are detected in account balances at interim dates, the auditor may be required to modify the planned nature, timing, or extent of the substantive tests covering the remaining period that relate to such accounts or to reperform certain auditing procedures at the balance-sheet date. The assessment of possible error as of the balance-sheet date should be based on the auditor's judgment of the state of the particular account(s) as of that date, after considering (a) the possible implications of the nature and cause of the errors detected at the interim date, (b) the possible relationship to other phases of the audit, (c) the corrections subsequently recorded by the entity, and (d) the results of auditing procedures covering the remaining period (including those that are responsive to the particular possibilities for error). For example, the auditor might conclude that the estimate of unrecorded credit memos at an interim date is representative of such errors at the balance-sheet date, based on substantive tests covering the remaining period. On the other hand, the assessment of the possible effects at the balance-sheet date of other types of cutoff errors at an interim date might be based on the results of reperforming substantive tests of the cutoff.

³ Factors to be considered in determining the relative mix of tests of details and analytical review procedures include (1) the nature of the transactions and balances in relation to the assertions involved, (2) the availability of historical data or other criteria for use in analytical review procedures, and (3) the availability of records required for effective tests of details and the nature of the tests to which they are susceptible.

Coordinating the Timing of Auditing Procedures

.10 The timing of auditing procedures also involves consideration of whether related auditing procedures are properly coordinated. This includes, for example—

- a. Coordinating the auditing procedures applied to related party transactions and balances.⁴
- b. Coordinating the testing of interrelated accounts and accounting cutoffs.
- c. Maintaining temporary audit control over assets that are readily negotiable and simultaneously testing such assets and cash on hand and in banks, bank loans, and other related items.

Decisions about coordinating related auditing procedures should be made in the light of the degree of reliance, if any, placed on internal accounting controls in a particular situation and of the particular auditing procedures that could be applied, either for the remaining period or at year-end, or both.

⁴ See Statement on Auditing Standards No. 45, *Omnibus Statement on Auditing Standards—1983*, amendment number two.

AU Section 315***Communications Between
Predecessor and
Successor Auditors***

(Supersedes section 543.18)

Source: SAS No. 7.

See section 9315 for interpretations of this section.

Effective November 30, 1975, unless otherwise indicated.*

.01 The purpose of this section is to provide guidance on communications between predecessor and successor auditors when a change of auditors has taken place or is in process. The term "predecessor auditor" refers to an auditor who has resigned or who has been notified that his services have been terminated. The term "successor auditor" refers to an auditor who has accepted an engagement or an auditor who has been invited to make a proposal for an engagement. This section applies whenever an independent auditor has been retained, or is to be retained, to make an examination of financial statements in accordance with generally accepted auditing standards.

.02 The initiative in communicating rests with the successor auditor. The communication may be either written or oral. Both the predecessor and successor auditors should hold in confidence information obtained from each other. This obligation applies whether or not the successor accepts the engagement.

.03 Prior to acceptance of the engagement, the successor auditor should attempt certain communications that are described in paragraphs .04 through .07. Other communications between the successor and the predecessor, described in paragraphs .08 and .09 are advisable. However, their timing is more flexible. The successor may attempt these other communications either prior to acceptance of the engagement or subsequent thereto.

Communications Before Successor Accepts Engagement

.04 Inquiry of the predecessor auditor is a necessary procedure because the predecessor may be able to provide the successor with information that will assist him in determining whether to accept the engagement. The successor should bear in mind that, among other things, the predecessor and the client may have disagreed about accounting principles, auditing procedures, or similarly significant matters.

* See paragraph .12.

.05 The successor auditor should explain to his prospective client the need to make an inquiry of the predecessor and should request permission to do so. Except as permitted by the Rules of Conduct, an auditor is precluded from disclosing confidential information obtained in the course of an audit engagement unless the client consents. Thus, the successor auditor should ask the prospective client to authorize the predecessor to respond fully to the successor's inquiries. If a prospective client refuses to permit the predecessor to respond or limits the response, the successor auditor should inquire as to the reasons and consider the implications of that refusal in deciding whether to accept the engagement.

.06 The successor auditor should make specific and reasonable inquiries of the predecessor regarding matters that the successor believes will assist him in determining whether to accept the engagement. His inquiries should include specific questions regarding, among other things, facts that might bear on the integrity of management; on disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters; and on the predecessor's understanding as to the reasons for the change of auditors.

.07 The predecessor auditor should respond promptly and fully, on the basis of facts known to him, to the successor's reasonable inquiries. However, should he decide, due to unusual circumstances such as impending litigation, not to respond fully to the inquiries, he should indicate that his response is limited. If the successor auditor receives a limited response, he should consider its implications in deciding whether to accept the engagement.

Other Communications

.08 When one auditor succeeds another, the successor auditor must obtain sufficient competent evidential matter to afford a reasonable basis for expressing his opinion on the financial statements he has been engaged to examine as well as on the consistency of the application of accounting principles in that year as compared with the preceding year. This may be done by applying appropriate auditing procedures to the account balances at the beginning of the period under examination and in some cases to transactions in prior periods. The successor auditor's examination may be facilitated by (a) making specific inquiries of the predecessor regarding matters that the successor believes may affect the conduct of his examination, such as audit areas that have required an inordinate amount of time or audit problems that arose from the condition of the accounting system and records and (b) reviewing the predecessor auditor's working papers. In reporting on his examination, however, the successor auditor should not make reference to the report or work of the predecessor auditor as the basis, in part, for his own opinion.

.09 The successor auditor should request the client to authorize the predecessor to allow a review of the predecessor's working papers. It is customary in such circumstances for the predecessor auditor to make himself available to the successor auditor for consultation and to make available for review certain of his working papers. The predecessor and successor auditors should agree on those working papers that are to be made available for review and those that may be copied. Ordinarily, the predecessor should permit the successor to review working papers relating to matters of continuing accounting significance, such as the working paper analysis of balance sheet accounts, both current and noncurrent, and those relating to contingencies. Valid business reasons, however, may lead the predecessor auditor to decide not to allow a review of his working papers. Further, when more than one successor auditor is considering acceptance of an engagement, the predecessor auditor should

not be expected to make himself or his working papers available until the successor has accepted the engagement.

Financial Statements Reported on by Predecessor

.10 If during his examination the successor auditor becomes aware of information that leads him to believe that financial statements reported on by the predecessor auditor may require revision, he should request his client to arrange a meeting among the three parties to discuss this information and attempt to resolve the matter.¹ If the client refuses or if the successor is not satisfied with the result, the successor auditor may be well advised to consult with his attorney in determining an appropriate course of further action.

[.11] [Superseded by Statement on Auditing Standards No. 15, effective for periods ending after June 30, 1977.] (See section 505 in Appendix G.)

Effective Date

.12 Statements on Auditing Standards generally are effective at the time of their issuance. However, since this Statement provides for practices that may differ in certain respects from practices heretofore considered acceptable it will be effective with respect to changes in auditors in which the successor auditor's consideration of acceptance of an engagement begins after November 30, 1975.

[The next page is 239.]

¹ See sections 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, and 711.11—12, *Filings Under Federal Securities Statutes*, for guidance on action to be taken by the predecessor auditor. [Reference changed by issuance of Statement on Auditing Standards No. 37.]

AU Section 316***The Auditor's Responsibility to
Detect and Report Errors and
Irregularities***

(Supersedes section 327 [See Appendix G])

Source: SAS No. 53.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section provides guidance on the independent auditor's responsibility for the detection of errors and irregularities in an audit of financial statements in accordance with generally accepted auditing standards. It describes factors that influence the auditor's ability to detect errors and irregularities and explains how the exercise of due care should give appropriate consideration to the possibility of errors or irregularities. It also provides guidance on the auditor's responsibility to communicate detected matters both within and outside the entity whose financial statements are under audit.

Definition of Errors and Irregularities

.02 The term *errors* refers to *unintentional* misstatements or omissions of amounts or disclosures in financial statements. Errors may involve—

- Mistakes in gathering or processing accounting data from which financial statements are prepared.
- Incorrect accounting estimates arising from oversight or misinterpretation of facts.
- Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure.¹

.03 The term *irregularities* refers to *intentional* misstatements or omissions of amounts or disclosures in financial statements. Irregularities include fraudulent financial reporting undertaken to render financial statements misleading, sometimes called *management fraud*, and misappropriation of assets, sometimes called *defalcations*. Irregularities may involve acts such as the following:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
- Misrepresentation or intentional omission of events, transactions, or other significant information

¹ Errors do not include the effect of accounting processes employed for convenience, such as maintaining accounting records on the cash basis or the tax basis and periodically adjusting those records to prepare financial statements in conformity with generally accepted accounting principles.

- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

.04 The primary factor that distinguishes errors from irregularities is whether the underlying cause of a misstatement in financial statements is intentional or unintentional. Intent, however, is often difficult to determine, particularly in matters involving accounting estimates or the application of accounting principles. For example, an unreasonable accounting estimate may result from unintentional bias or may be an intentional attempt to misstate the financial statements.

The Auditor's Responsibility to Detect Errors and Irregularities

.05 The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.^{2, 3}

.06 The auditor's assessment of the risk of material misstatement of the financial statements requires the auditor to understand the characteristics of errors and irregularities that are discussed in paragraph .34 and the complex interaction of those characteristics. Based on that understanding, the auditor designs and performs appropriate audit procedures and evaluates the results.

.07 Because of the characteristics of irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material irregularity. For example, generally accepted auditing standards do not require that an auditor authenticate documents, nor is the auditor trained to do so. Also, audit procedures that are effective for detecting a misstatement that is unintentional may be ineffective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client.

.08 The auditor should exercise (a) due care in planning, performing, and evaluating the results of audit procedures, and (b) the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected. Since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement exists in the financial statements does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor.

Consideration of the Possibility of Material Misstatements in Audit Planning

.09 In developing an audit plan, the auditor should consider factors influencing audit risk that relates to several or all account balances and obtain

²The concept of reasonable assurance is recognized in the third standard of fieldwork, "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination" and is discussed in section 326, *Evidential Matter*, and section 350, *Audit Sampling*.

³The auditor's responsibility for detecting misstatements resulting from illegal acts, as defined in section 317, *Illegal Acts By Clients*, having a direct and material effect on the determination of financial statement amounts is the same as that for other errors and irregularities.

an understanding of the internal control structure.⁴ These matters often have effects pervasive to the financial statements taken as a whole and also influence the auditor's consideration of risk at the account balance or class-of-transactions level.

Consideration of Audit Risk at the Financial Statement Level

.10 An assessment of the risk of material misstatements should be made during planning. The auditor's understanding of the internal control structure should either heighten or mitigate the auditor's concern about the risk of material misstatements. The factors considered in assessing risk should be considered in combination to make an overall judgment; the presence of some factors in isolation would not necessarily indicate increased risk. Factors such as those listed below may be considered.

Management Characteristics

- Management operating and financing decisions are dominated by a single person.
- Management's attitude toward financial reporting is unduly aggressive.
- Management (particularly senior accounting personnel) turnover is high.
- Management places undue emphasis on meeting earnings projections.
- Management's reputation in the business community is poor.

Operating and Industry Characteristics

- Profitability of entity relative to its industry is inadequate or inconsistent.
- Sensitivity of operating results to economic factors (inflation, interest rates, unemployment, etc.) is high.
- Rate of change in entity's industry is rapid.
- Direction of change in entity's industry is declining with many business failures.
- Organization is decentralized without adequate monitoring.
- Internal or external matters that raise substantial doubt about the entity's ability to continue as a going concern are present. (See section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.)

Engagement Characteristics

- Many contentious or difficult accounting issues are present.
- Significant difficult-to-audit transactions or balances are present.
- Significant and unusual related party transactions not in the ordinary course of business are present.
- Nature, cause (if known), or the amount of known and likely misstatements detected in the audit of prior period's financial statements is significant.
- It is a new client with no prior audit history or sufficient information is not available from the predecessor auditor.

⁴ See section 319, *Consideration of the Internal Control Structure in a Financial Statement Audit*.

.11 The size, complexity, and ownership characteristics of the entity have a significant influence on the risk factors considered to be important. For example, for a large entity, the auditor would ordinarily give consideration to factors that constrain improper conduct by senior management, such as the effectiveness of the board of directors, the audit committee or others with equivalent authority and responsibility,⁵ and the internal audit function. Consideration would also be given to the measures taken to enforce a formal code of conduct and the effectiveness of the budgeting or responsibility reporting system. For a small entity some of these matters might be considered inapplicable or unimportant, particularly if the auditor's past experience with the entity has been that effective owner-manager or trustee involvement creates a good control environment.

.12 The auditor should assess the risk of management misrepresentation by reviewing information obtained about risk factors and the internal control structure. Matters such as the following may be considered:

- Are there known circumstances that may indicate a management predisposition to distort financial statements, such as frequent disputes about aggressive application of accounting principles that increase earnings, evasive responses to audit inquiries, or excessive emphasis on meeting quantified targets that must be achieved to receive a substantial portion of management compensation?
- Are there indications that management has failed to establish policies and procedures that provide reasonable assurance of reliable accounting estimates, such as personnel who develop estimates appearing to lack necessary knowledge and experience, supervisors of these personnel appearing careless or inexperienced, or there is a history of unreliable or unreasonable estimates?
- Are there conditions that indicate lack of control of activities, such as constant crisis conditions in operating or accounting areas, disorganized work areas, frequent or excessive back orders, shortages, delays, or lack of documentation for major transactions?
- Are there indications of a lack of control over computer processing, such as a lack of controls over access to applications that initiate or control the movement of assets (for example, a demand deposit application in a bank), high levels of processing errors, or unusual delays in providing processing results and reports?
- Are there indications that management has not developed or communicated adequate policies and procedures for security of data or assets, such as not investigating employees in key positions before hiring, or allowing unauthorized personnel to have ready access to data or assets?

.13 The auditor should consider the effect of the matters described in paragraphs .10 to .12 on the overall audit strategy and the expected conduct and scope of the audit.

The Auditor's Response to Risk at the Financial Statement Level

.14 The auditor's overall judgment about the level of risk in an engagement may affect engagement staffing, extent of supervision, overall strategy

⁵ For entities that do not have audit committees, the phrase "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities.

for expected conduct and scope of audit, and degree of professional skepticism applied. Thus, the auditor's assessment of risk may affect audit planning in one or more of the following ways. The experience and training of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the level of risk for the engagement. Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement. Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of the balance sheet date, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence. Higher risk will also ordinarily cause the auditor to exercise a heightened degree of professional skepticism in conducting the audit (see paragraphs .16 to .21).

The Auditor's Consideration of Audit Risk at the Balance or Class Level

.15 The following matters are examples of factors that may influence the auditor's consideration of risk of material misstatement related to particular assertions at the balance or class level:⁶

- Effect of risk factors identified at the financial statement or engagement level on the particular account balance or transaction class
- Complexity and contentiousness of accounting issues affecting balance or class
- Frequency or significance of difficult-to-audit transactions affecting balance or class
- Nature, cause, and amount of known and likely misstatements detected in the balance or class in the prior audit
- Susceptibility of related assets to misappropriation
- Competence and experience of personnel assigned to processing data that affect the balance or class
- Extent of judgment involved in determining the total balance or class
- Size and volume of individual items constituting the balance or class
- Complexity of calculations affecting the balance or class

Professional Skepticism

.16 An audit of financial statements in accordance with generally accepted auditing standards should be planned and performed with an attitude of professional skepticism. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Rather, the auditor recognizes that conditions observed and evidential matter obtained, including information from prior audits, need to be objectively evaluated to determine whether the financial statements are free of material misstatement.

.17 Management integrity is important because management can direct subordinates to record transactions or conceal information in a manner that can materially misstate financial statements. When approaching difficult-to-substantiate assertions, the auditor should recognize the increased importance of his consideration of factors that bear on management integrity. A presumption of management dishonesty, however, would be contrary to the accumu-

⁶ Additional factors relating to risk assessment are found in section 312, *Audit Risk and Materiality in Conducting an Audit*.

lated experience of auditors. Moreover, if dishonesty were presumed, the auditor would potentially need to question the genuineness of all records and documents obtained from the client and would require conclusive rather than persuasive evidence to corroborate all management representations. An audit conducted on these terms would be unreasonably costly and impractical.

Professional Skepticism in Audit Planning

.18 Whenever the auditor has reached a conclusion that there is significant risk of material misstatement of the financial statements, the auditor reacts in one or more ways. The auditor should consider this assessment in determining the nature, timing, or extent of procedures, assigning staff, or requiring appropriate levels of supervision. The auditor may identify specific transactions involving senior management and confirm the details with appropriate external parties and review in detail all material accounting entries prepared or approved by senior management.

.19 The auditor should consider whether accounting policies are acceptable in the circumstances. However, when the auditor has reached a conclusion that there is significant risk of intentional distortion of financial statements, the auditor should recognize that management's selection and application of significant accounting policies, particularly those related to revenue recognition, asset valuation, and capitalization versus expensing, may be misused. Increased risk of intentional distortion of the financial statements should cause greater concern about whether accounting principles that are otherwise generally accepted are being used in inappropriate circumstances to create a distortion of earnings. For example, management might use the percentage of completion method in circumstances that do not justify its use to misstate operating results.

.20 When evaluation at the financial statement level indicates significant risk, the auditor requires more or different evidence to support material transactions than would be the case in the absence of such risk. For example, the auditor may perform additional procedures to determine that sales are properly recorded, giving consideration to the possibility that the buyer has a right to return the product. Transactions that are both large and unusual, particularly at year-end, should be selected for testing.

Professional Skepticism in Performance of the Audit

.21 In performing procedures and gathering evidential matter, the auditor continually maintains an attitude of professional skepticism. The performance of auditing procedures during the audit may result in the detection of conditions or circumstances that should cause the auditor to consider whether material misstatements exist. If a condition or circumstance differs adversely from the auditor's expectation, the auditor needs to consider the reason for such a difference. Examples of such conditions or circumstances are as follows:

- Analytical procedures disclose significant differences from expectations.
- Significant unreconciled differences between reconciliations of a control account and subsidiary records or between a physical count and a related account are not appropriately investigated and corrected on a timely basis.
- Confirmation requests disclose significant differences or yield fewer responses than expected.
- Transactions selected for testing are not supported by proper documentation or are not appropriately authorized.

- Supporting records or files that should be readily available are not promptly produced when requested.
- Audit tests detect errors that apparently were known to client personnel, but were not voluntarily disclosed to the auditor.

When such conditions or circumstances exist, the planned scope of audit procedures should be reconsidered. As the number of differences from expectations or the frequency with which the auditor is unable to obtain satisfactory explanations increases, the auditor should consider whether the assessment of the risk of material misstatement of the financial statements made in the planning stage of the engagement is still appropriate.

Evaluation of Audit Test Results

.22 The auditor should evaluate the significance of differences between the accounting records and the underlying facts and circumstances detected by the application of auditing procedures. The auditor should consider both the quantitative and qualitative aspects of these matters and whether they are indicative of an error or an irregularity. Often a particular matter considered in isolation cannot be identified as an error or irregularity; nevertheless, this evaluation is important. Because irregularities are intentional, they have implications beyond their direct monetary effect and the auditor needs to consider the implications for other aspects of the audit.

.23 The auditor's objective is to reach a conclusion on whether the financial statements, taken as a whole, are materially misstated. The auditor should accumulate potential audit adjustments during the audit and summarize and evaluate the combined effect. In this regard, the auditor may designate an amount below which potential audit adjustments need not be accumulated. This amount would be set so that any such adjustments, either individually or when aggregated with other adjustments, would not be material to the financial statements.

.24 If the auditor has determined that an audit adjustment is, or may be, an irregularity, but has also determined that the effect on the financial statements could not be material, the auditor should—

- a. Refer the matter to an appropriate level of management that is at least one level above those involved.
- b. Be satisfied that, in view of the organizational position of the likely perpetrator, the irregularity has no implications for other aspects of the audit or that those implications have been adequately considered.

For example, irregularities involving misappropriation of cash from a small imprest fund would normally be of little significance because both the manner of operating the fund and its size would tend to establish a limit on the amount of loss and the custodianship of such a fund is normally entrusted to a relatively low-level employee.

.25 If the auditor has determined that an audit adjustment is, or may be, an irregularity and has either determined that the effect could be material or has been unable to evaluate potential materiality, the auditor should—

- a. Consider the implications for other aspects of the audit.
- b. Discuss the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved.

- c. Attempt to obtain sufficient competent evidential matter to determine whether, in fact, material irregularities exist and, if so, their effect.
- d. If appropriate, suggest that the client consult with legal counsel on matters concerning questions of law.

The Effect of Irregularities on the Audit Report

.26 If the auditor has concluded that the financial statements are materially affected by an irregularity, the auditor should insist that the financial statements be revised and, if they are not, express a qualified or an adverse opinion on the financial statements, disclosing all substantive reasons for his opinion.

.27 If the auditor is precluded from applying necessary procedures, or if, after the application of extended procedures, the auditor is unable to conclude whether possible irregularities may materially affect the financial statements, the auditor should—

- a. Disclaim or qualify an opinion on the financial statements.
- b. Communicate his findings to the audit committee or the board of directors.

If the client refuses to accept the auditor's report as modified for the circumstances described above, the auditor should withdraw from the engagement and communicate the reasons for withdrawal to the audit committee or board of directors. Whether the auditor concludes that withdrawal from the engagement is appropriate in other circumstances depends on the diligence and cooperation of senior management and the board of directors in investigating the circumstances and taking appropriate remedial action. For example, if the auditor is precluded by the client from obtaining reasonably available evidential matter, withdrawal ordinarily would be appropriate. However, because of the variety of circumstances that may arise, it is not possible to describe all those circumstances when withdrawal would be appropriate.

Communications Concerning Errors or Irregularities

.28 For the audit committee⁷ to make the informed judgments necessary to fulfill its responsibility for the oversight of financial reporting, the auditor should assure himself that the audit committee is adequately informed about any irregularities of which the auditor becomes aware during the audit unless those irregularities are clearly inconsequential.⁸ For example, a minor defalcation by an employee at a low level in the organization might be considered inconsequential. However, irregularities involving senior management of which the auditor becomes aware should be reported directly to the audit committee. Irregularities that are individually immaterial may be reported to the audit committee on an aggregate basis, and the auditor may reach an understanding with the audit committee on the nature and amount of reportable irregularities.

.29 Disclosure of irregularities to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and would be precluded by the auditor's ethical or legal obligation of confidentiality unless the matter affects his opinion on the financial statements. The auditor should recognize, however,

⁷ See footnote 5.

⁸ The auditor's responsibility to communicate errors within certain entities whose financial statements are under audit is described in section 380, *Communication With Audit Committees*.

that in the following circumstances a duty to disclose outside the client may exist:

- a. When the entity reports an auditor change under the appropriate securities law on Form 8-K⁹
- b. To a successor auditor when the successor makes inquiries in accordance with section 315, *Communications Between Predecessor and Successor Auditors*¹⁰
- c. In response to a subpoena
- d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing irregularities with parties outside the client.

Responsibilities in Other Circumstances

.30 This section describes the auditor's responsibilities to detect and report errors and irregularities in an audit of a complete set of financial statements made in accordance with generally accepted auditing standards. In other engagements, the auditor's responsibilities may be more extensive or more restricted, depending on the terms of the engagement.

.31 The auditor may accept an engagement that necessitates a more extensive responsibility to detect or report irregularities. For example, in an audit in accordance with *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, 1981 Revision*, issued by the U.S. General Accounting Office, the auditor should be aware that such standards go beyond generally accepted auditing standards as they relate to notification when the audit indicates that irregularities may exist. These standards require the auditor not only to promptly report instances of irregularities to the audited entity's management, but also to report the matter to the funding agency or other specified agency.

.32 When an examination does not encompass a complete set of financial statements or a complete individual financial statement, or when the scope is less extensive than an audit in accordance with generally accepted auditing standards, the auditor's ability to detect material misstatements may be considerably reduced. For example, in an engagement to report on specified elements, accounts, or items of financial statements, the auditor's procedures focus on the specific element, account, or item and the special purpose of the engagement. In these circumstances, the auditor's assessment of risk at the financial statement level and other aspects of the examination that relate to the entity and its financial statements taken as a whole is necessarily more restricted.

Effective Date

.33 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

⁹ Disclosure to the Securities and Exchange Commission may be necessary if, among other matters, the auditor withdraws because the board of directors has not taken appropriate remedial action. Such failure may be a reportable disagreement on Form 8-K.

¹⁰ In accordance with section 315, communications between predecessor and successor auditors require the specific permission of the client.

.34 Appendix

Characteristics of Errors and Irregularities

1. Characteristics of errors and irregularities that are relevant because of their potential influence on the auditor's ability to detect such matters are materiality of the effect on financial statements, level of management or employees involved, extent and skillfulness of any concealment, relationship to established specific control procedures, and the specific financial statements affected.

Materiality

2. Section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .04, states that "financial statements are materially misstated when they contain errors or irregularities whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly in conformity with generally accepted accounting principles." Section 312.13, also states: "The auditor generally plans the audit primarily to detect errors that he believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements." As used in section 312, the term *errors* refers to both errors and irregularities.

3. In planning the audit, the auditor is concerned with matters that could be material to the financial statements. An audit in accordance with generally accepted auditing standards may detect errors or irregularities that are not material to the financial statements, but such an audit can provide no assurance of detecting immaterial errors or irregularities. In this regard, there is no important distinction between errors and irregularities. There is a distinction, however, in the auditor's response to detected matters. Generally, an isolated, immaterial error in processing accounting data or applying accounting principles is not significant to the audit. In contrast, detection of an irregularity requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

Level of Involvement

4. An irregularity may be caused by an employee or by management and, if by management, by a relatively high or low level of management. The experience of auditors indicates that the level of involvement often combines with other characteristics in ways that have an influence on the auditor's ability to detect.

5. Defalcations by employees are often immaterial in amount and concealed in a manner that does not misstate net assets or net income. This type of irregularity can be more efficiently and effectively dealt with by an effective internal control structure and fidelity bonding of employees.

6. Material irregularities perpetrated by senior levels of management, including an owner-manager of a small business, are infrequent, but when they do occur they often engender widespread attention. These irregularities may not be susceptible to prevention or detection by specific control procedures because senior management is above the controls that deter employees or may override these controls with relative ease. Culture, custom, and the corporate governance system inhibit irregularities by senior management, but are not infallible deterrents. For this reason, an audit in accordance with generally accepted auditing standards necessarily gives due consideration to factors that bear on management integrity and the control environment.

Concealment

7. Concealment is any attempt by the perpetrator of an irregularity to reduce the likelihood of detection. Concealment usually involves manipulation of accounting records or supporting documents to disguise the fact that the accounting records are not in agreement with the underlying facts and circumstances. Concealment can be skillful and elaborate or clumsy and limited. The auditor's ability to detect a concealed irregularity depends on the skillfulness of the perpetrator, the frequency and extent of manipulation, and the relative size of individual amounts manipulated.

8. Forgery may be used to create false signatures, other signs of authenticity, or entire documents. Collusion may result in falsified confirmations or other evidence of validity. Also, unrecorded transactions are normally more difficult to detect than concealment achieved by manipulation of recorded transactions. However, the effect of concealment on the ability to detect an irregularity is dependent on the particular circumstances. For example, an attempt to mislead users of financial statements by recording large, fictitious revenue transactions late in the period without supporting documentation would be more readily detected than fictitious revenue transactions spread throughout the period, individually immaterial in amount, and supported by legitimate-appearing invoices and shipping documents. Moreover, both of these irregularities might be extremely difficult, if not impossible, to detect if collusion of customers is added to the concealment scheme.

Internal Control Structure

9. A lack of control procedures could permit an error or irregularity to occur repeatedly and the repeated occurrence could accumulate to a material amount. However, the auditor may not detect an error or irregularity that results from a nonrecurring breakdown of a specific control procedure because a rare item permitted by temporary conditions may not come to light in the performance of analytical or other procedures.

10. Irregularities may also be perpetrated or concealed by circumvention of specific control procedures or may be perpetrated by a level of management above specific control procedures. These types of irregularities are generally more difficult for an auditor to detect. However, the auditor should consider whether there are circumstances or factors that indicate a higher risk of these types of irregularities and modify auditing procedures accordingly.

Financial Statement Effect

11. Other matters remaining equal, errors or irregularities that involve overstatement will generally be more readily detected than those that involve understatement because the audit evidence available is more reliable for detecting such errors or irregularities. Also, misstatements that are charged to the income statement are less likely to be detected than those that are concealed in the balance sheet, because the process of comparing recorded accountability with the existing assets should detect significant errors concealed in the balance sheet.

Summary

12. The foregoing discussion considers characteristics of errors and irregularities individually and explains the effect an individual characteristic tends to have on the auditor's detection ability. However, these characteristics may interact in particular circumstances in ways that also affect the auditor's ability to detect a specific error or irregularity.

[The next page is 251.]

AU Section 317

Illegal Acts By Clients

(Supersedes section 328 [See Appendix G])

Source: SAS No. 54.

See section 9317 for interpretations of this section.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section prescribes the nature and extent of the consideration an independent auditor should give to the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted auditing standards. The section also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

Definition of Illegal Acts

.02 The term *illegal acts*, for purposes of this section, refers to violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

Dependence on Legal Judgment

.03 Whether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence. An auditor, in reporting on financial statements, presents himself as one who is proficient in accounting and auditing. The auditor's training, experience, and understanding of the client and its industry may provide a basis for recognition that some client acts coming to his attention may be illegal. However, the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

Relation to Financial Statements

.04 Illegal acts vary considerably in their relation to the financial statements. Generally, the further removed an illegal act is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to become aware of the act or to recognize its possible illegality.

.05 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts. However, the auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statements assertions rather than from the perspective of legality *per se*. The auditor's responsibility to detect and report misstatements resulting from

illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors and irregularities as described in section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*.

.06 Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects, and their financial statement effect is indirect. An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. For example, securities may be purchased or sold based on inside information. While the direct effects of the purchase or sale may be recorded appropriately, their indirect effect, the possible contingent liability for violating securities laws, may not be appropriately disclosed. Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

The Auditor's Consideration of the Possibility of Illegal Acts

.07 As explained in paragraph .05, certain illegal acts have a direct and material effect on the determination of financial statement amounts. Other illegal acts, such as those described in paragraph .06, may, in particular circumstances, be regarded as having material but indirect effects on financial statements. The auditor's responsibility with respect to detecting, considering the financial statement effects of, and reporting these other illegal acts is described in this section. These other illegal acts are hereinafter referred to simply as *illegal acts*. The auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, because of the characteristics of illegal acts explained above, an audit made in accordance with generally accepted auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed.

Audit Procedures in the Absence of Evidence Concerning Possible Illegal Acts

.08 Normally, an audit in accordance with generally accepted auditing standards does not include audit procedures specifically designed to detect illegal acts. However, procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention. For example, such procedures include reading minutes; inquiring of the client's management and legal counsel concerning litigation, claims, and assessments; performing substantive tests of details of transactions or balances. The auditor should make inquiries of management concerning the

client's compliance with laws and regulations. Where applicable, the auditor should also inquire of management concerning—

- The client's policies relative to the prevention of illegal acts.
- The use of directives issued by the client and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations.

The auditor also ordinarily obtains written representations from management concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency. (See section 333, *Client Representations*.) The auditor need perform no further procedures in this area absent specific information concerning possible illegal acts.

Specific Information Concerning Possible Illegal Acts

.09 In applying audit procedures and evaluating the results of those procedures, the auditor may encounter specific information that may raise a question concerning possible illegal acts, such as the following:

- Unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete or timely manner in order to maintain accountability for assets
- Investigation by a governmental agency, an enforcement proceeding, or payment of unusual fines or penalties
- Violations of laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor
- Large payments for unspecified services to consultants, affiliates, or employees
- Sales commissions or agents' fees that appear excessive in relation to those normally paid by the client or to the services actually received
- Unusually large payments in cash, purchases of bank cashiers' checks in large amounts payable to bearer, transfers to numbered bank accounts, or similar transactions
- Unexplained payments made to government officials or employees
- Failure to file tax returns or pay government duties or similar fees that are common to the entity's industry or the nature of its business

Audit Procedures in Response to Possible Illegal Acts

.10 When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor should inquire of management at a level above those involved, if possible. If management does not provide satisfactory information that there has been no illegal act, the auditor should—

- a. Consult with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. Arrangements for such consultation with client's legal counsel should be made by the client.
- b. Apply additional procedures, if necessary, to obtain further understanding of the nature of the acts.

.11 The additional audit procedures considered necessary, if any, might include procedures such as the following:

- a. Examine supporting documents, such as invoices, canceled checks, and agreements and compare with accounting records.
- b. Confirm significant information concerning the matter with the other party to the transaction or with intermediaries, such as banks or lawyers.
- c. Determine whether the transaction has been properly authorized.
- d. Consider whether other similar transactions or events may have occurred, and apply procedures to identify them.

The Auditor's Response to Detected Illegal Acts

.12 When the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.

The Auditor's Consideration of Financial Statement Effect

.13 In evaluating the materiality of an illegal act that comes to his attention, the auditor should consider both the quantitative and qualitative materiality of the act. For example, section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .07, states that "an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue."

.14 The auditor should consider the effect of an illegal act on the amounts presented in financial statements including contingent monetary effects, such as fines, penalties and damages. Loss contingencies resulting from illegal acts that may be required to be disclosed should be evaluated in the same manner as other loss contingencies. Examples of loss contingencies that may arise from an illegal act are: threat of expropriation of assets, enforced discontinuance of operations in another country, and litigation.

.15 The auditor should evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity's operations. If material revenue or earnings are derived from transactions involving illegal acts, or if illegal acts create significant unusual risks associated with material revenue or earnings, such as loss of a significant business relationship, that information should be considered for disclosure.

Implications for Audit

.16 The auditor should consider the implications of an illegal act in relation to other aspects of the audit, particularly the reliability of representations of management. The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures and the level of management or employees involved.

Communication With the Audit Committee

.17 The auditor should assure himself that the audit committee, or others with equivalent authority and responsibility, is adequately informed with

respect to illegal acts that come to the auditor's attention.¹ The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated. The communication should describe the act, the circumstances of its occurrence, and the effect on the financial statements. Senior management may wish to have its remedial actions communicated to the audit committee simultaneously. Possible remedial actions include disciplinary action against involved personnel, seeking restitution, adoption of preventive or corrective company policies, and modifications of specific control procedures. If senior management is involved in an illegal act, the auditor should communicate directly with the audit committee. The communication may be oral or written. If the communication is oral, the auditor should document it.

Effect on the Auditor's Report

.18 If the auditor concludes that an illegal act has a material effect on the financial statements, and the act has not been properly accounted for or disclosed, the auditor should express a qualified opinion or an adverse opinion on the financial statements taken as a whole, depending on the materiality of the effect on the financial statements.

.19 If the auditor is precluded by the client from obtaining sufficient competent evidential matter to evaluate whether an illegal act that could be material to the financial statements has, or is likely to have, occurred, the auditor generally should disclaim an opinion on the financial statements.

.20 If the client refuses to accept the auditor's report as modified for the circumstances described in paragraphs .18 and .19, the auditor should withdraw from the engagement and indicate the reasons for withdrawal in writing to the audit committee or board of directors.

.21 The auditor may be unable to determine whether an act is illegal because of limitations imposed by the circumstances rather than by the client or because of uncertainty associated with interpretation of applicable laws or regulations or surrounding facts. In these circumstances, the auditor should consider the effect on his report.²

Other Considerations in an Audit in Accordance With Generally Accepted Auditing Standards

.22 In addition to the need to withdraw from the engagement, as described in paragraph .20, the auditor may conclude that withdrawal is necessary when the client does not take the remedial action that the auditor considers necessary in the circumstances even when the illegal act is not material to the financial statements. Factors that should affect the auditor's conclusion include the implications of the failure to take remedial action, which may affect the auditor's ability to rely on management representations, and the effects of continuing association with the client. In reaching a conclusion on such matters, the auditor may wish to consult with his own legal counsel.

.23 Disclosure of an illegal act to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and such disclosure would be precluded by

¹ For entities that do not have audit committees, the phrase "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities.

² See section 508, *Reports on Audited Financial Statements*.

the auditor's ethical or legal obligation of confidentiality, unless the matter affects his opinion on the financial statements. The auditor should recognize, however, that in the following circumstances a duty to notify parties outside the client may exist:

- a. When the entity reports an auditor change under the appropriate securities law on Form 8-K ³
- b. To a successor auditor when the successor makes inquiries in accordance with section 315, *Communications Between Predecessor and Successor Auditors* ⁴
- c. In response to a subpoena
- d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing illegal acts with parties outside the client.

Responsibilities in Other Circumstances

.24 An auditor may accept an engagement that entails a greater responsibility for detecting illegal acts than that specified in this section. For example, a governmental unit may engage an independent auditor to perform an audit in accordance with the Single Audit Act of 1984. In such an engagement, the independent auditor is responsible for testing and reporting on the governmental unit's compliance with certain laws and regulations applicable to Federal financial assistance programs. Also, an independent auditor may undertake a variety of other special engagements. For example, a corporation's board of directors or its audit committee may engage an auditor to apply agreed-upon procedures and report on compliance with the corporation's code of conduct under the attestation standards.

Effective Date

.25 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

³ Disclosure to the Securities and Exchange Commission may be necessary if, among other matters, the auditor withdraws because the board of directors has not taken appropriate remedial action. Such failure may be a reportable disagreement on Form 8-K.

⁴ In accordance with section 315, communications between predecessor and successor auditors require the specific permission of the client.

AU Section 319

Consideration of the Internal Control Structure in a Financial Statement Audit

(Supersedes section 320 [See Appendix G]) *

Source: SAS No. 55.

Effective for audits of financial statements for periods beginning on or after January 1, 1990, unless otherwise indicated.

.01 This section provides guidance on the independent auditor's consideration of an entity's internal control structure in an audit of financial statements in accordance with generally accepted auditing standards.¹ It describes the elements of an internal control structure and explains how an auditor should consider the internal control structure in planning and performing an audit.

Summary

.02 An entity's internal control structure, for purposes of this section, consists of three elements: the control environment, the accounting system, and control procedures. In all audits, the auditor should obtain a sufficient understanding of each of the three elements to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

.03 After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure) because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the auditor may obtain evidential matter about the effectiveness of both the design and operation of a policy or procedure that supports a lower assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.

.04 After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control

* This section also supersedes Auditing Interpretations of section 320, *The Auditor's Study and Evaluation of Internal Control* (section 9320.01—.06 [See Appendix G]).

¹ This section revises the second standard of fieldwork of the ten generally accepted auditing standards as follows:

A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.

.05 The auditor uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

Elements of an Internal Control Structure

.06 An entity's internal control structure consists of the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. Although the internal control structure may include a wide variety of objectives and related policies and procedures, only some of these may be relevant to an audit of the entity's financial statements. Generally, the policies and procedures that are relevant to an audit pertain to the entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the financial statements.² Other policies and procedures, however, may be relevant if they pertain to data the auditor uses to apply auditing procedures. For example, policies and procedures pertaining to nonfinancial data that the auditor uses in analytical procedures, such as production statistics, may be relevant in an audit.

.07 An entity generally has internal control structure policies and procedures that are not relevant to an audit and therefore need not be considered. For example, policies and procedures concerning the effectiveness, economy, and efficiency of certain management decision-making processes, such as the appropriate price to charge for its products, or whether to make expenditures for certain research and development or advertising activities, although important to the entity, do not ordinarily relate to a financial statement audit.

.08 For purposes of an audit of financial statements, an entity's internal control structure consists of the three following elements:

- The control environment
- The accounting system
- Control procedures

Dividing the internal control structure into these three elements facilitates discussion of its nature and how the auditor considers it in an audit. The auditor's primary consideration, however, is whether an internal control structure policy or procedure affects financial statement assertions rather than its classification into any particular category.

Control Environment

.09 The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include the following:

- Management's philosophy and operating style
- The entity's organizational structure
- The functioning of the board of directors and its committees, particularly the audit committee

² The terms *financial statement assertions* and *assertions* are used throughout this section to refer to the five categories of management's assertions that are embodied in the account balance, transaction class, and disclosure components of financial statements as discussed in section 326, *Evidential Matter*, paragraphs .03—.08.

- Methods of assigning authority and responsibility
- Management's control methods for monitoring and following up on performance, including internal auditing
- Personnel policies and practices
- Various external influences that affect an entity's operations and practices, such as examinations by bank regulatory agencies

The control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity. (The control environment factors are discussed in greater detail in paragraph .66.)

Accounting System

.10 The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will—

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

Control Procedures

.11 Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system. Generally, they may be categorized as procedures that pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties that reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure the proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed

controls, management review of reports that summarize the detail of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

General Considerations

.12 The applicability and importance of specific control environment factors, accounting system methods and records, and control procedures that an entity establishes should be considered in the context of—

- The entity's size.
- Its organization and ownership characteristics.
- The nature of its business.
- The diversity and complexity of its operations.
- Its methods of processing data.
- Its applicable legal and regulatory requirements.

For example, a formal written code of conduct or an organizational structure that provides for formal delegation of authority may be significant to the control environment of a large entity. However, a small entity with effective owner-manager involvement may not need a formal code or organizational structure. Similarly, a small entity with effective owner-manager involvement may not need extensive accounting procedures, sophisticated accounting records, or formal control procedures, such as a formal credit policy, information security policy, or competitive bidding procedures.

.13 Establishing and maintaining an internal control structure is an important management responsibility. To provide reasonable assurance that an entity's objectives will be achieved, the internal control structure should be under ongoing supervision by management to determine that it is operating as intended and that it is modified as appropriate for changes in conditions.

.14 The concept of reasonable assurance recognizes that the cost of an entity's internal control structure should not exceed the benefits that are expected to be derived. Although the cost-benefit relationship is a primary criterion that should be considered in designing an internal control structure, the precise measurement of costs and benefits usually is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgments in evaluating the cost-benefit relationship.

.15 The potential effectiveness of an entity's internal control structure is subject to inherent limitations. Mistakes in the application of policies and procedures may arise from such causes as misunderstanding of instructions, mistakes in judgment, and personal carelessness, distraction, or fatigue. Furthermore, the policies and procedures that require segregation of duties can be circumvented by collusion among persons both within and outside the entity and by management override of certain policies or procedures.

Consideration of the Internal Control Structure in Planning an Audit

.16 The auditor should obtain a sufficient understanding of each of the three elements of the entity's internal control structure to plan the audit of the entity's financial statements. The understanding should include knowledge about the design of relevant policies, procedures, and records and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to—

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatements.
- Design substantive tests.

.17 Whether an internal control structure policy or procedure has been *placed in operation* is different from its *operating effectiveness*. In obtaining knowledge about whether policies, procedures, or records have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the policy, procedure, or record was applied, the consistency with which it was applied, and by whom. This section does not require the auditor to obtain knowledge about operating effectiveness as part of the understanding of the internal control structure.

.18 The auditor's understanding of the internal control structure may sometimes raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentations in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records may cause the auditor to conclude that it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements.

Understanding the Internal Control Structure

.19 In making a judgment about the understanding of the internal control structure necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatements that could occur, the risk that such misstatements may occur, and the factors that influence the design of substantive tests. Other sources of such knowledge include previous audits and the understanding of the industry in which the entity operates. The auditor also considers his assessments of inherent risk, his judgments about materiality, and the complexity and sophistication of the entity's operations and systems, including whether the method of controlling data processing is based on manual procedures independent of the computer or is highly dependent on computerized controls. As an entity's operations and systems become more complex and sophisticated, it may be necessary to devote more attention to internal control structure elements to obtain the understanding of them that is necessary to design effective substantive tests. For example, when auditing past due loans of a financial institution that uses computer-produced reports of such loans, the auditor may be unable to design appropriate substantive tests without knowledge of the specific control procedures concerning the completeness and classification of loans.

Understanding of Control Environment

.20 The auditor should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment. The auditor should concentrate on the substance of management's policies, procedures, and related actions rather than their form because management may establish appropriate policies and procedures but not act on them. For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on. Similarly, management may establish a formal code of conduct but act in a manner that condones violations of that code.

Understanding of Accounting System

.21 The auditor should obtain sufficient knowledge of the accounting system to understand—

- The classes of transactions in the entity's operations that are significant to the financial statements.
- How those transactions are initiated.
- The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

Understanding of Control Procedures

.22 Because some control procedures are integrated in specific components of the control environment and accounting system, as the auditor obtains an understanding of the control environment and accounting system, he is also likely to obtain knowledge about some control procedures. For example, in obtaining an understanding of the documents, records, and processing steps in the accounting system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether it is necessary to devote additional attention to obtaining an understanding of control procedures to plan the audit. Ordinarily, audit planning does not require an understanding of the control procedures related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to those components.

Procedures to Obtain Understanding

.23 In obtaining an understanding of the internal control structure policies and procedures that are relevant to audit planning, the auditor should perform procedures to provide sufficient knowledge of the design of the relevant policies, procedures, and records pertaining to each of the three internal control structure elements and whether they have been placed in operation. This knowledge is ordinarily obtained through previous experience with the entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular policy or procedure, and the nature of the entity's documentation of specific policies and procedures.

.24 For example, the auditor's prior experience with the entity may provide an understanding of its classes of transactions. Inquiries of appropriate entity personnel and inspection of documents and records, such as source documents, journals, and ledgers, may provide an understanding of the accounting records designed to process those transactions and whether they

have been placed in operation. Similarly, in obtaining an understanding of the design of computer-programmed control procedures and whether they have been placed in operation, the auditor may make inquiries of appropriate entity personnel and inspect relevant systems documentation to understand control procedure design and may inspect exception reports generated as a result of such control procedures to determine that they have been placed in operation.

.25 The auditor's assessments of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of the internal control structure.

Documentation of Understanding

.26 The auditor should document the understanding of the entity's internal control structure elements obtained to plan the audit. The form and extent of this documentation is influenced by the size and complexity of the entity, as well as the nature of the entity's internal control structure. For example, documentation of the understanding of the internal control structure of a large complex entity may include flowcharts, questionnaires, or decision tables. For a small entity, however, documentation in the form of a memorandum may be sufficient. Generally, the more complex the internal control structure and the more extensive the procedures performed, the more extensive the auditor's documentation should be.

Consideration of the Internal Control Structure in Assessing Control Risk

.27 Section 326, *Evidential Matter*, states that most of the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. These assertions are embodied in the account balance, transaction class, and disclosure components of financial statements and are classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

In planning and performing an audit, an auditor considers these assertions in the context of their relationship to a specific account balance or class of transactions.

.28 The risk of material misstatement³ in financial statement assertions consists of inherent risk, control risk, and detection risk. Inherent risk is the susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures. Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control

³ For purposes of this section, a material misstatement in a financial statement assertion is an error or irregularity as defined in section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, that either individually or when aggregated with other errors or irregularities in other assertions would be material to the financial statements taken as a whole.

structure policies or procedures. Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion.

.29 Assessing control risk is the process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting material misstatements in the financial statements. Control risk should be assessed in terms of financial statement assertions. After obtaining the understanding of the internal control structure, the auditor may assess control risk at the maximum level for some or all assertions because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient.⁴

.30 Assessing control risk at below the maximum level involves—

- Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.
- Performing tests of controls to evaluate the effectiveness of such policies and procedures.

.31 In identifying internal control structure policies and procedures relevant to specific financial statement assertions, the auditor should consider that the policies and procedures can have either a pervasive effect on many assertions or a specific effect on an individual assertion, depending on the nature of the particular internal control structure element involved. The control environment and accounting system often have a pervasive effect on a number of account balances or transaction classes and, therefore, can often affect many assertions. For example, the conclusion that an entity's control environment is highly effective may influence the auditor's decision about the number of an entity's locations at which auditing procedures are to be performed or whether to perform certain auditing procedures for some account balances or transaction classes at an interim date. Either decision affects the way in which auditing procedures are applied to specific assertions, even though the auditor may not have specifically considered each individual assertion that is affected by such decisions.

.32 Conversely, some control procedures often have a specific effect on an individual assertion embodied in a particular account balance or transaction class. For example, the control procedures that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence assertion for the inventory account balance.

.33 Internal control structure policies and procedures can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that policy or procedure may be in reducing control risk for that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing control risk for that assertion than policies and procedures more directly related to that assertion, such as matching shipping documents with billing documents.

⁴ Control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms that range, for example, from a maximum to a minimum. The term *maximum level* is used in this section to mean the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure.

.34 Procedures directed toward either the effectiveness of the design or operation of an internal control structure policy or procedure are referred to as tests of controls. Tests of controls directed toward the effectiveness of the design of an internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests to obtain such evidential matter ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports, and observation of the application of specific internal control structure policies and procedures. For entities with a complex internal control structure, the auditor should consider that the use of flowcharts, questionnaires, or decision tables might facilitate the application of tests of design.

.35 Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied during the audit period, and by who it was applied. These tests ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports indicating performance of the policy or procedure, observation of the application of the policy or procedure, and reperformance of the application of the policy or procedure by the auditor. In some circumstances, a specific procedure may address the effectiveness of both design and operation. However, a combination of procedures may be necessary to evaluate the effectiveness of the design or operation of an internal control structure policy or procedure.

.36 The conclusion reached as a result of assessing control risk is referred to as the *assessed level of control risk*. In determining the evidential matter necessary to support a specific assessed level of control risk at below the maximum level, the auditor should consider the characteristics of evidential matter about control risk discussed in paragraphs .46 through .60. Generally, however, the lower the assessed level of control risk, the greater the assurance the evidential matter must provide that the internal control structure policies and procedures relevant to an assertion are designed and operating effectively.

.37 The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the auditing procedures to be used to detect material misstatements in the financial statement assertions. Auditing procedures designed to detect such misstatements are referred to in this section as substantive tests.

.38 As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase. Consequently, the auditor may do one or more of the following:

- Change the nature of substantive tests from a less effective to a more effective procedure, such as using tests directly toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity.
- Change the timing of substantive tests, such as performing them at year end rather than at an interim date.
- Change the extent of substantive tests, such as using a larger sample size.

Documentation of the Assessed Level of Control Risk

.39 In addition to the documentation of the understanding of the internal control structure discussed in paragraph .26, the auditor should document the basis for his conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. However, for those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions where the assessed level of control risk is below the maximum level, the auditor should document the basis for his conclusion that the effectiveness of the design and operation of internal control structure policies and procedures supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk used, the nature of the entity's internal control structure, and the nature of the entity's documentation of its internal control structure.

Relationship of Understanding to Assessing Control Risk

.40 Although understanding the internal control structure and assessing control risk are discussed separately in this section, they may be performed concurrently in an audit. The objective of procedures performed to obtain an understanding of the internal control structure (discussed in paragraphs .23 through .25) is to provide the auditor with knowledge necessary for audit planning. The objective of tests of controls (discussed in paragraphs .34 through .35) is to provide the auditor with evidential matter to use in assessing control risk. However, procedures performed to achieve one objective may also pertain to the other objective.

.41 Based on the assessed level of control risk the auditor expects to support and audit efficiency considerations, the auditor often plans to perform some tests of controls concurrently with obtaining the understanding of the internal control structure. In addition, even though some of the procedures performed to obtain the understanding may not have been specifically planned as tests of controls, they may also provide evidential matter about the effectiveness of both the design and operation of the policies and procedures relevant to certain assertions and, consequently, serve as tests of controls. For example, in obtaining an understanding of the control environment, the auditor may have made inquiries about management's use of budgets, observed management's comparison of monthly budgeted and actual expenses, and inspected reports pertaining to the investigation of variances between budgeted and actual amounts. Although these procedures provide knowledge about the design of the entity's budgeting policies and whether they have been placed in operation, they may also provide evidential matter about the effectiveness of the design and operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses. In some circumstances, that evidential matter may be sufficient to support an assessed level of control risk that is below the maximum level for the presentation and disclosure assertions pertaining to expenses in the income statement.

.42 When the auditor concludes that procedures performed to obtain the understanding of the internal control structure also provide evidential matter for assessing control risk, he should consider the guidance in paragraphs .46 through .60 in judging the degree of assurance provided by that evidential matter. Although such evidential matter may not provide sufficient assurance

to support an assessed level of control risk that is below the maximum level of certain assertions, it may do so for other assertions and thus provide a basis for modifying the nature, timing, or extent of the substantive tests that the auditor plans for those assertions. However, such procedures are not sufficient to support an assessed level of control risk below the maximum level if they do not provide sufficient evidential matter to evaluate the effectiveness of both the design and operation of a policy or procedure relevant to an assertion.

Further Reduction in the Assessed Level of Control Risk

.43 After obtaining the understanding of the internal control structure and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether additional evidential matter sufficient to support a further reduction is likely to be available, and whether it would be efficient to perform tests of controls to obtain that evidential matter. The results of the procedures performed to obtain the understanding of the internal control structure, as well as pertinent information from other sources, help the auditor to evaluate those two factors.

.44 In considering efficiency, the auditor recognizes that additional evidential matter that supports a further reduction in the assessed level of control risk for an assertion would result in less audit effort for the substantive tests of that assertion. The auditor weighs the increase in audit effort associated with the additional tests of controls that is necessary to obtain such evidential matter against the resulting decrease in audit effort associated with the reduced substantive tests. When the auditor concludes it is inefficient to obtain additional evidential matter for specific assertions, the auditor uses the assessed level of control risk based on the understanding of the internal control structure in planning the substantive tests for those assertions.

.45 For those assertions for which the auditor performs additional tests of controls, the auditor determines the assessed level of control risk that the results of those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those assertions and, accordingly, in determining the nature, timing, and extent of substantive tests for such assertions.

Evidential Matter to Support the Assessed Level of Control Risk

.46 When the auditor assesses control risk at below the maximum level, he should obtain sufficient evidential matter to support that assessed level. The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditing judgment. Evidential matter varies substantially in the assurance it provides to the auditor as he develops an assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusion to which it leads, all bear on the degree of assurance evidential matter provides.

.47 These characteristics influence the nature, timing, and extent of the tests of controls that the auditor applies to obtain evidential matter about control risk. The auditor selects such tests from a variety of techniques such as inquiry, observation, inspection, and reperformance of a policy or procedure that pertains to an assertion. No one specific test of controls is always necessary, applicable, or equally effective in every circumstance.

Type of Evidential Matter

.48 The nature of the particular policies and procedures that pertain to an assertion influences the type of evidential matter that is available to evaluate the effectiveness of the design or operation of those policies and procedures. For some policies and procedures, documentation of design or operation may exist. In such circumstances, the auditor may decide to inspect the documentation to obtain evidential matter about the effectiveness of design or operation.

.49 For other policies and procedures, however, such documentation may not be available or relevant. For example, documentation of design or operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control procedures, such as segregation of duties or some control procedures performed by a computer. In such circumstances, evidential matter about the effectiveness of design or operation may be obtained through observation or the use of computer-assisted audit techniques to reperform the application of relevant policies and procedures.

Source of Evidential Matter

.50 Generally, evidential matter about the effectiveness of the design and operation of policies and procedures obtained directly by the auditor, such as through observation, provides more assurance than evidential matter obtained indirectly or by inference, such as through inquiry. For example, evidential matter about the proper segregation of duties that is obtained by the auditor's direct personal observation of the individual who applies a control procedure generally provides more assurance than making inquiries about the individual. The auditor should consider, however, that the observed application of a policy or procedure might not be performed in the same manner when the auditor is not present.

.51 Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of design or operation of a specific control procedure. When the auditor determines that a specific control procedure may have a significant effect in reducing control risk to a low level for a specific assertion, he ordinarily needs to perform additional tests to obtain sufficient evidential matter to support the conclusion about the effectiveness of the design or operation of that control procedure.

Timeliness of Evidential Matter

.52 The timeliness of the evidential matter concerns when it was obtained and the portion of the audit period to which it applies. In evaluating the degree of assurance that is provided by evidential matter, the auditor should consider that the evidential matter obtained by some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied. Consequently, such evidential matter may be insufficient to evaluate the effectiveness of the design or operation of internal control structure policies and procedures for periods not subjected to such tests. In such circumstances, the auditor may decide to supplement these tests with other tests of controls that are capable of providing evidential matter about the entire audit period. For example, for a control procedure performed by a computer program, the auditor may test the operation of the control at a particular point in time to obtain evidential matter about whether the program executes the control effectively. The auditor may then perform tests of controls directed toward the design and operation of other control procedures pertaining to the modification and the use of that computer program during

the audit period to obtain evidential matter about whether the programmed control procedure operated consistently during the audit period.

.53 Evidential matter about the effective design or operation of internal control structure policies and procedures that was obtained in prior audits may be considered by the auditor in assessing control risk in the current audit. To evaluate the use of such evidential matter for the current audit, the auditor should consider the significance of the assertion involved, the specific internal control structure policies and procedures that were evaluated during the prior audits, the degree to which the effective design and operation of those policies and procedures were evaluated, the results of the tests of controls used to make those evaluations, and the evidential matter about design or operation that may result from substantive tests performed in the current audit. The auditor should also consider that the longer the time elapsed since the performance of tests of controls to obtain evidential matter about control risk, the less assurance it may provide.

.54 When considering evidential matter obtained from prior audits, the auditor should obtain evidential matter in the current period about whether changes have occurred in the internal control structure, including its policies, procedures, and personnel, subsequent to the prior audits, as well as the nature and extent of any such changes. Consideration of evidential matter about these changes, together with the considerations in the preceding paragraph, may support either increasing or decreasing the additional evidential matter about the effectiveness of design and operation to be obtained in the current period.

.55 When the auditor obtains evidential matter about the design or operation of internal control structure policies and procedures during an interim period, he should determine what additional evidential matter should be obtained for the remaining period. In making that determination, the auditor should consider the significance of the assertion involved, the specific internal control structure policies and procedures that were evaluated during the interim period, the degree to which the effective design and operation of those policies and procedures were evaluated, the results of the tests of controls used to make that evaluation, the length of the remaining period, and the evidential matter about design or operation that may result from the substantive test performed in the remaining period. The auditor should obtain evidential matter about the nature and extent of any significant changes in the internal control structure, including its policies, procedures, and personnel, that occur subsequent to the interim period.

Interrelationship of Evidential Matter

.56 The auditor should consider the combined effect of various types of evidential matter relating to the same assertion in evaluating the degree of assurance that evidential matter provides. In some circumstances, a single type of evidential matter may not be sufficient to evaluate the effective design or operation of an internal control structure policy or procedure. To obtain sufficient evidential matter in such circumstances, the auditor may perform other tests of controls pertaining to that policy or procedure. For example, an auditor may observe that programmers are not authorized to operate the computer. Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with inquiries about the frequency and circumstances under which programmers may have access to the computer and may inspect documentation of past instances when programmers attempted to operate the computer to determine how such attempts were prevented or detected.

.57 In addition, when evaluating the degree of assurance provided by evidential matter, the auditor should consider the interrelationship of an entity's control environment, accounting system, and control procedures. Although an individual internal control structure element may affect the nature, timing, or extent of substantive tests for a specific financial statement assertion, the auditor should consider the evidential matter about an individual element in relation to the evidential matter about the other elements in assessing control risk for a specific assertion.

.58 Generally, when various types of evidential matter support the same conclusion about the design or operation of an internal control structure policy or procedure, the degree of assurance provided increases. Conversely, if various types of evidential matter lead to different conclusions about the design or operation of an internal control structure policy or procedure, the assurance provided decreases. For example, based on the evidential matter that the control environment is effective, the auditor may have reduced the number of locations at which auditing procedures will be performed. If, however, when evaluating specific control procedures, the auditor obtains evidential matter that such procedures are ineffective, he may reevaluate his conclusion about the control environment and, among other things, decide to perform auditing procedures at additional locations.

.59 Similarly, evidential matter indicating that the control environment is ineffective may adversely affect an otherwise effective accounting system or control procedure for a particular assertion. For example, a control environment that is likely to permit unauthorized changes in a computer program may reduce the assurance provided by evidential matter obtained from evaluating the effectiveness of the program at a particular point in time. In such circumstances, the auditor may decide to obtain additional evidential matter about the design and operation of that program during the audit period. For example, the auditor might obtain and control a copy of the program and use computer-assisted audit techniques to compare that copy with the program that the entity uses to process data.

.60 An audit of financial statements is a cumulative process; as the auditor assesses control risk, the information obtained may cause him to modify the nature, timing, or extent of the other planned tests of controls for assessing control risk. In addition, information may come to the auditor's attention as a result of performing substantive tests or from other sources during the audit that differs significantly from the information on which his planned tests of controls for assessing control risk were based. For example, the extent of misstatements that the auditor detects by performing substantive tests may alter his judgment about the assessed level of control risk. In such circumstances, the auditor may need to reevaluate the planned substantive procedures, based on a revised consideration of the assessed level of control risk for all or some of the financial statement assertions.

Correlation of Control Risk With Detection Risk

.61 The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that material misstatements exist in the financial statements. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such misstatements may exist in the financial statements. The auditor uses this evidential matter as part of the reasonable basis for an opinion referred to in the third standard of field work, which follows:

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

.62 After considering the level to which he seeks to restrict the risk of a material misstatement in the financial statements and the assessed levels of inherent risk and control risk, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed level of control risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the substantive tests performed.

.63 Although the inverse relationship between control risk and detection risk may permit the auditor to change the nature or the timing of substantive tests or limit their extent, ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for all of the assertions relevant to significant account balances or transaction classes. Consequently, regardless of the assessed level of control risk, the auditor should perform substantive tests for significant account balances and transaction classes.

.64 The substantive tests that the auditor performs consist of tests of details of transactions and balances, and analytical procedures. In assessing control risk, the auditor also may use tests of details of transactions as tests of controls. The objective of tests of details of transactions performed as substantive tests is to detect material misstatements in the financial statements. The objective of tests of details of transactions performed as tests of controls is to evaluate whether an internal control structure policy or procedure operated effectively. Although these objectives are different, both may be accomplished concurrently through performance of a test of details on the same transaction. The auditor should recognize, however, that careful consideration should be given to the design and evaluation of such tests to ensure that both objectives will be accomplished.

Effective Date

.65 This section is effective for audits of financial statements for periods beginning on or after January 1, 1990. Early application of the provisions of this section is permissible.

Appendix A

.66 Control Environment Factors

1. This appendix discusses the control environment factors identified in paragraph .09.

Management Philosophy and Operating Style

2. Management philosophy and operating style encompass a broad range of characteristics. Such characteristics may include the following: management's approach to taking and monitoring business risks; management's attitudes and actions toward financial reporting; and management's emphasis on meeting budget, profit, and other financial and operating goals. These characteristics have a significant influence on the control environment, particularly when management is dominated by one or a few individuals, regardless of the consideration given to the other control environment factors.

Organizational Structure

3. An entity's organizational structure provides the overall framework for planning, directing, and controlling operations. An organizational structure includes consideration of the form and nature of an entity's organizational units, including the data processing organization, and related management functions and reporting relationships. In addition, the organizational structure should assign authority and responsibility within the entity in an appropriate manner.

Audit Committee

4. An effective audit committee takes an active role in overseeing an entity's accounting and financial reporting policies and practices. The committee should assist the board of directors in fulfilling its fiduciary and accountability responsibilities and should help maintain a direct line of communication between the board and the entity's external and internal auditors.

Methods of Assigning Authority and Responsibility

5. These methods affect the understanding of reporting relationships and responsibilities established within the entity. Methods of assigning authority and responsibility include consideration of—

- Entity policy regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct.
- Assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- Employee job descriptions delineating specific duties, reporting relationships, and constraints.
- Computer systems documentation indicating the procedures for authorizing transactions and approving systems changes.

Management Control Methods

6. These methods affect management's direct control over the exercise of authority delegated to others and its ability to effectively supervise overall company activities. Management control methods include consideration of—

- Establishing planning and reporting systems that set forth management's plans and the results of actual performance. Such systems may include business planning; budgeting, forecasting, and profit planning; and responsibility accounting.
- Establishing methods that identify the status of actual performance and exceptions from planned performance, as well as communicating them to the appropriate levels of management.
- Using such methods at appropriate management levels to investigate variances from expectations and to take appropriate and timely corrective action.
- Establishing and monitoring policies for developing and modifying accounting systems and control procedures, including the development, modification, and use of any related computer programs and data files.

Internal Audit Function

7. The internal audit function is established within an entity to examine and evaluate the adequacy and effectiveness of other internal control structure policies and procedures. Establishing an effective internal audit function includes consideration of its authority and reporting relationships, the qualifications of its staff, and its resources.*

Personnel Policies and Practices

8. These policies and practices affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Personnel policies and practices include consideration of an entity's policies and procedures for hiring, training, evaluating, promoting, and compensating employees, and giving them the resources necessary to discharge their assigned responsibilities.

External Influences

9. These are influences established and exercised by parties outside an entity that affect an entity's operations and practices. They include monitoring and compliance requirements imposed by legislative and regulatory bodies, such as examinations by bank regulatory agencies. They also include review and follow-up by parties outside the entity concerning entity actions. External influences are ordinarily outside an entity's authority. Such influences, however, may heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations and may also prompt management to establish specific internal control structure policies or procedures.

* Section 322, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination*, provides guidance about factors that affect the auditor's consideration of the work of internal auditors in an audit.

Appendix B

.67 Glossary of Selected Terms and Concepts

Accounting system The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.

Assertions Management representations that are embodied in the account balance, transaction class, and disclosure components of financial statements. They include (1) existence or occurrence, (2) completeness, (3) rights and obligations, (4) valuation or allocation and (5) presentation and disclosure.

Assessed level of control risk The level of control risk the auditor uses in determining the detection risk to accept for a financial statement assertion and, accordingly, in determining the nature, timing, and extent of substantive tests. This level may vary along a range from maximum to minimum as long as the auditor has obtained evidential matter to support that assessed level.

Assessing control risk The process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting misstatements in financial statement assertions.

Control environment The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include (1) management philosophy and operating style, (2) organizational structure, (3) the function of the board of directors and its committees, (4) methods of assigning authority and responsibility, (5) management control methods, (6) the internal audit function, (7) personnel policies and practices, and (8) external influences concerning the entity.

Control procedures The policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved.

Control risk The risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure policies or procedures.

Detection risk The risk that the auditor will not detect a material misstatement that exists in an assertion.

Inherent risk The susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures.

Internal control structure The policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved.

Internal control structure policies and procedures relevant to an audit The policies and procedures in an entity's internal control structure that pertain to the entity's ability to record, process, summarize, and report financial data consistent with management's assertions embodied in the financial statements or that pertain to data the auditor uses to apply auditing procedures to financial statement assertions.

Maximum level of control risk The greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure.

Operating effectiveness How an internal control structure policy or procedure was applied, the consistency with which it was applied, and by whom.

Placed in operation An entity is using an internal control structure policy or procedure.

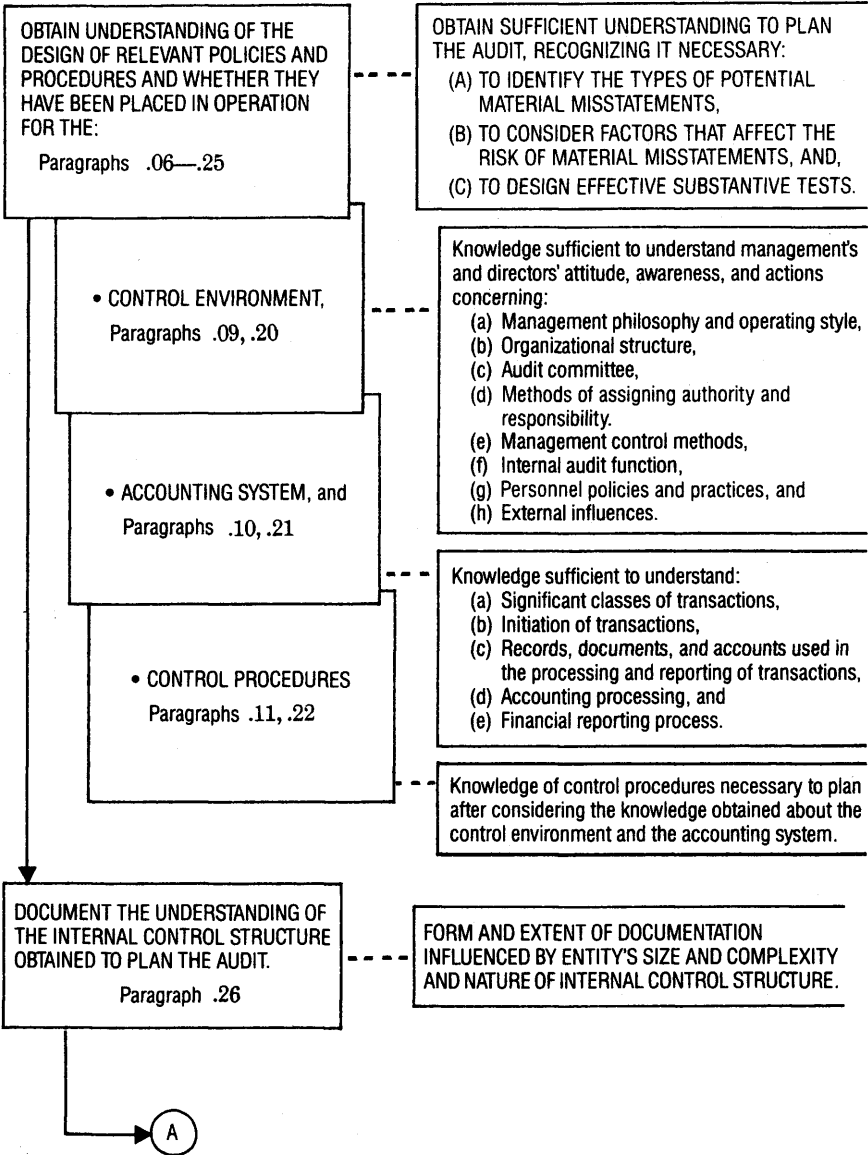
Substantive tests Tests of details and analytical procedures performed to detect material misstatements in the account balance, transaction class, and disclosure components of financial statements.

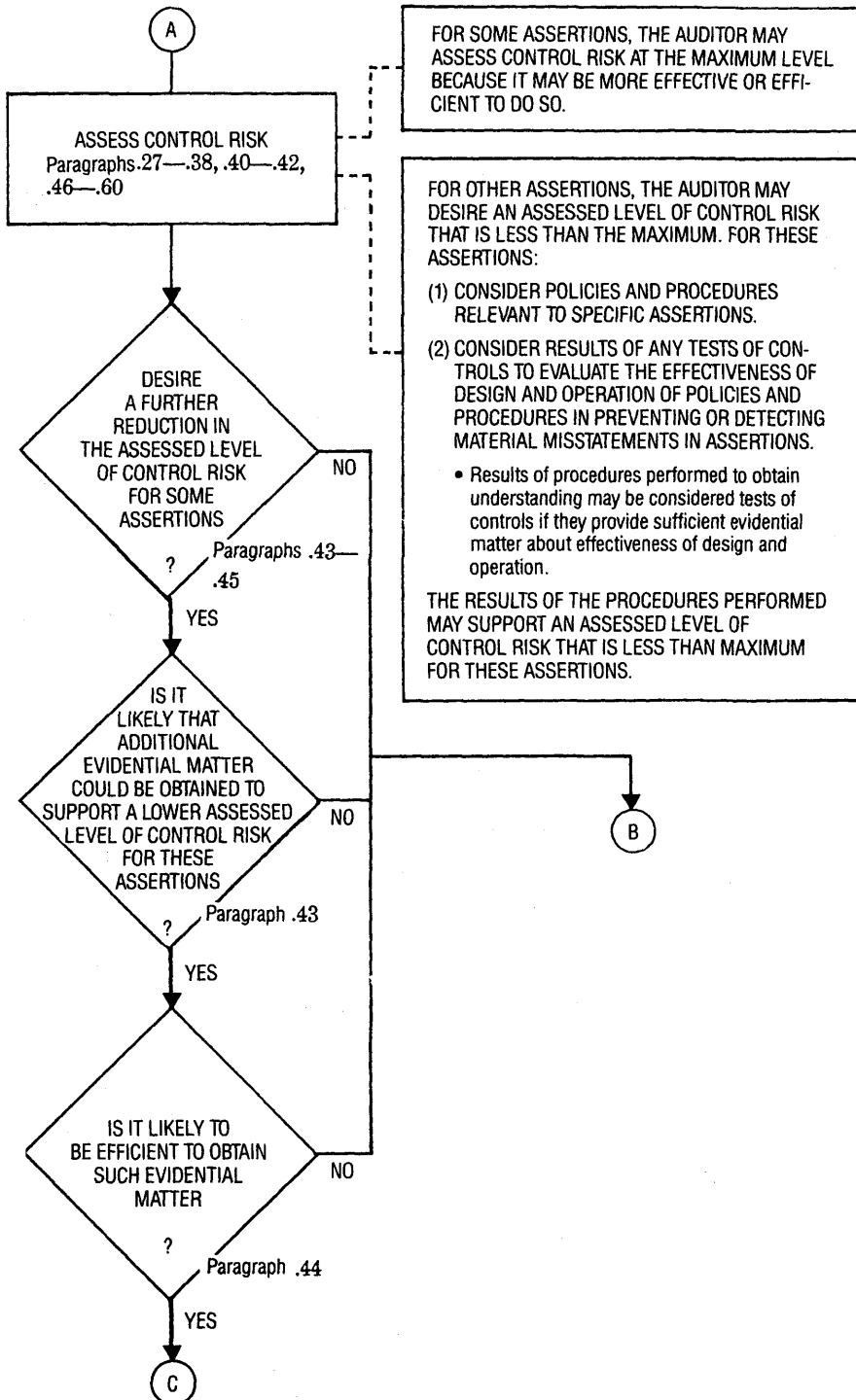
Tests of controls Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial statement assertion.

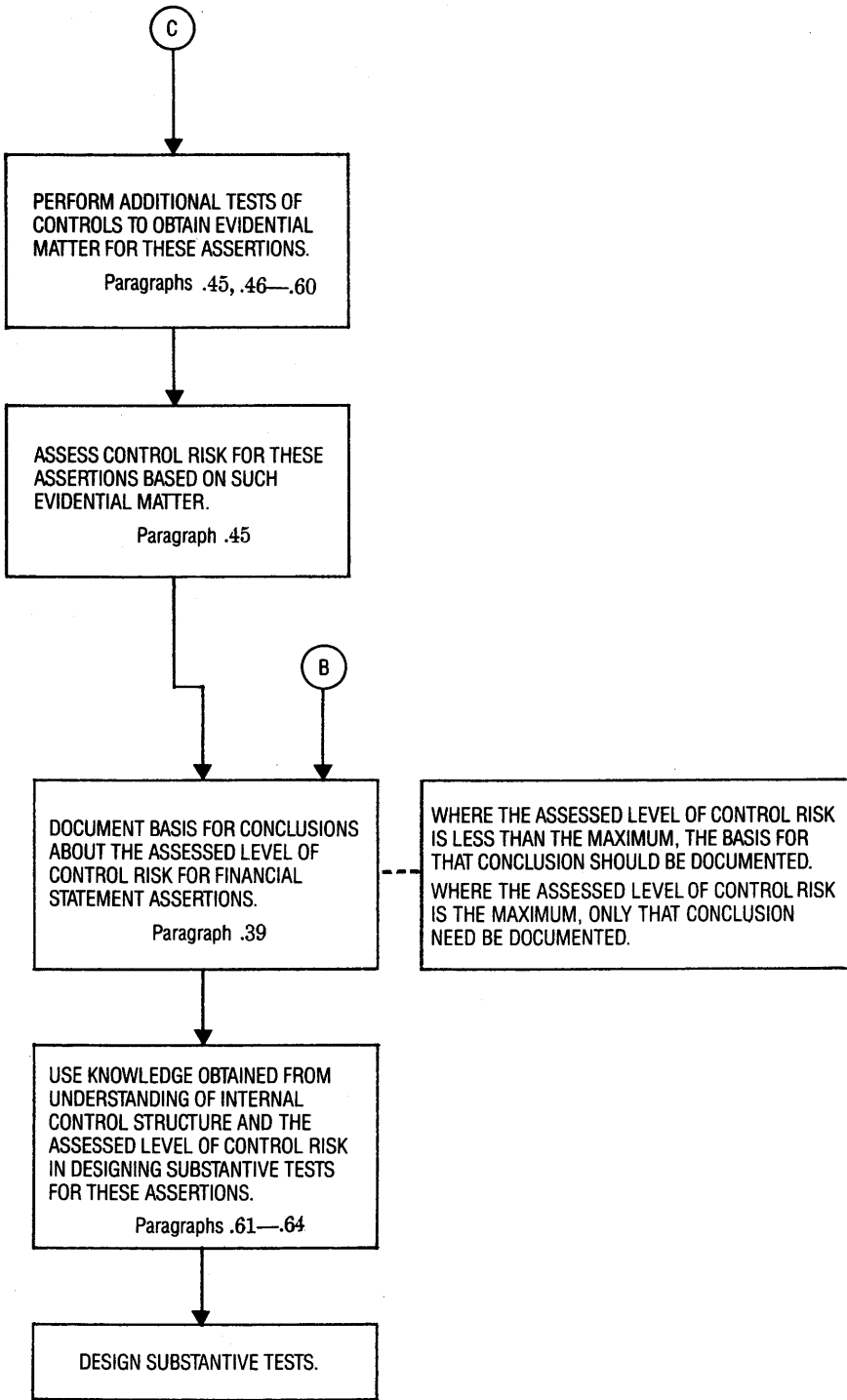
Understanding of the internal control structure The knowledge of the control environment, accounting system, and control procedures that the auditor believes is necessary to plan the audit.

Appendix C

.68 Flow Chart—Consideration of the Internal Control Structure in a Financial Statement Audit







Appendix D

.69 Other Selected Management Control Objectives

1. The concepts and terminology introduced in this section clarify and update former section 320, *The Auditor's Study and Evaluation of Internal Control* (See Appendix G), by incorporating the concepts concerning audit evidence and audit risk that have evolved in practice and that have been established by Statements on Auditing Standards issued subsequent to that section. This appendix discusses some of the basic concepts in section 320 that are implicit in an internal control structure but that are not explicitly discussed in this section. Although these concepts have general application, the organizational and procedural means for applying them may differ considerably from case to case because of the variety of circumstances involved.

Management Objectives

2. Establishing and maintaining an internal control structure is an important management responsibility. In establishing specific internal control structure policies and procedures concerning an entity's ability to record, process, summarize, and report financial data that is consistent with management's assertions embodied in the financial statements, some of the specific objectives management may wish to consider include the following:

- Transactions are executed in accordance with management's general or specific authorization.
- Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- Access to assets is permitted only in accordance with management's authorization.
- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Access to Assets

3. The objectives of safeguarding assets requires that access to assets be limited to authorized personnel. In this context, access to assets includes both direct physical access and indirect access through the preparation or processing of documents that authorize the use or disposition of assets. Access to assets is required in the normal operations of a business and, therefore, limiting access to authorized personnel is the maximum feasible constraint. The number and competence of personnel to whom access is authorized should be influenced by the nature of the assets and the related susceptibility to loss through errors and irregularities. Limitation of direct access to assets requires appropriate physical segregation and protective equipment or devices.

Comparison of Recorded Accountability With Assets

4. The purpose of comparing recorded accountability with assets is to determine whether the actual assets agree with the recorded accountability. Typical examples of this comparison include cash and securities counts, bank reconciliations, and physical inventories.

5. If the comparison reveals that the assets do not agree with the recorded accountability, it provides evidence of unrecorded or improperly recorded

transactions. The converse, however, does not necessarily follow. For example, agreement of cash count with the recorded balance does not provide evidence that all cash received has been properly recorded.

6. This illustrates an unavoidable distinction between fiduciary and recorded accountability: the former arises immediately upon acquisition of an asset; the latter arises only when the initial record of the transaction is prepared.

7. As to assets that are susceptible to loss through errors or irregularities, the comparison with recorded accountability should be made independently. The frequency with which such comparison should be made for the purpose of safeguarding assets depends on the nature and amount of the assets involved and the cost of making the comparison. For example, it may be reasonable to count cash daily but not reasonable to take a physical inventory at that interval. However, a daily inventory of products in the custody of route salesmen, for example, may be practicable as a means of determining their accountability for sales. Similarly, the value and vulnerability of some products may make frequent complete inventories worthwhile.

8. The frequency with which comparison of recorded accountability with assets should be made for the purpose of achieving reliability of the records for preparing financial statements depends on the materiality of the assets and their susceptibility to loss through errors and irregularities.

9. The action that may be appropriate with respect to any discrepancies revealed by the comparison of recorded accountability with assets will depend primarily on the nature of the asset, the system in use, and the amount and cause of the discrepancy. Appropriate action may include adjustment of the accounting records, filing of insurance claims, revision of procedures, or administrative action to improve the performance of personnel.

[The next page is 307.]

AU Section 322***The Effect of an Internal
Audit Function on the
Scope of the Independent
Auditor's Examination***

(Supersedes section 320.83)*

Source: SAS No. 9.

Issue date, unless otherwise indicated: December, 1975.

.01 The work of internal auditors cannot be substituted for the work of the independent auditor; however, the independent auditor should consider the procedures, if any, performed by internal auditors in determining the nature, timing, and extent of his own auditing procedures. This section provides guidance on the factors that affect an independent auditor's consideration of the work of internal auditors in an examination made in accordance with generally accepted auditing standards.

.02 Internal auditors often perform a number of services for management, including, but not limited to, studying and evaluating internal accounting control,¹ reviewing operating practices to promote increased efficiency and economy, and making special inquiries at management's direction. This section is applicable to the independent auditor's consideration, in making his study and evaluation of internal accounting control, of the work performed by internal auditors. The section applies whether the work performed by internal auditors is part of their normal duties or is performed at the request of the independent auditor. It also applies to situations in which internal auditors perform work directly for the independent auditor (see paragraph .10).

.03 When internal auditors study and evaluate internal accounting control or perform substantive tests of the details of transactions and balances, they serve a special function. They are not part of internal accounting control in the same manner as would be an individual who verifies the mathematical accuracy of all invoices; instead, they act as a separate, higher level of control to determine that the system is functioning effectively. This section is not applicable to personnel with the title "internal auditor" who do not perform such a function. Conversely, personnel with other titles who perform such a function should be considered internal auditors for purposes of this section.

.04 The independent auditor should acquire an understanding of the internal audit function as it relates to his study and evaluation of internal

* [Reference changed by the issuance of Statement on Auditing Standards No. 43. Subsequently changed by the issuance of Statement on Auditing Standards No. 48.]

¹ See section 320.51 (in Appendix G), for an explanation of the two phases of the study of internal accounting control. [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

accounting control. The work performed by internal auditors may be a factor in determining the nature, timing, and extent of the independent auditor's procedures. If the independent auditor decides that the work performed by internal auditors may have a bearing on his own procedures, he should consider the competence and objectivity of internal auditors and evaluate their work.

Reviewing the Competence and Objectivity of Internal Auditors

.05 Section 320.36 (see Appendix G), regarding the role of client personnel who perform accounting and related work with respect to accounting control, states in part:

Reasonable assurance that the objectives of accounting control are achieved depends on the competence and integrity of personnel, the independence of their assigned functions, and their understanding of the prescribed procedures.

[Reference changed by the issuance of Statement on Auditing Standards No. 48.]

.06 When considering the competence of internal auditors, the independent auditor should inquire about the qualifications of the internal audit staff, including, for example, consideration of the client's practices for hiring, training, and supervising the internal audit staff.

.07 When considering the objectivity of internal auditors, the independent auditor should consider the organizational level to which internal auditors report the results of their work and the organizational level to which they report administratively. This frequently is an indication of the extent of their ability to act independently of the individuals responsible for the functions being audited. One method for judging internal auditors' objectivity is to review the recommendations made in their reports.

Evaluating the Work of Internal Auditors

.08 In evaluating the work of internal auditors, the independent auditor should examine, on a test basis, documentary evidence of the work performed by internal auditors and should consider such factors as whether the scope of the work is appropriate, audit programs are adequate, working papers adequately document work performed, conclusions reached are appropriate in the circumstances, and any reports prepared are consistent with the results of the work performed. The independent auditor should also perform tests of some of the work of internal auditors. The extent of these tests will vary depending on the circumstances, including the type of transactions and their materiality. These tests may be accomplished by either (a) examining some of the transactions or balances that internal auditors examined or (b) examining similar transactions or balances but not those actually examined by internal auditors. The independent auditor should compare the results of his tests with the results of the internal auditors' work in reaching conclusions on that work.

Arrangements With Internal Auditors

.09 When the work of internal auditors is expected to be significant to the independent auditor's study and evaluation of internal accounting control, the independent auditor should, at the outset of the engagement, inform internal auditors of the reports and working papers he will need. He should also consult with internal auditors concerning work they are performing, since work not yet completed may also have a bearing on his examination. Also, work done by internal auditors will frequently be more useful to the independent auditor if plans for the work are discussed in advance.

Using Internal Auditors to Provide Direct Assistance to the Independent Auditor

.10 The independent auditor may make use of internal auditors to provide direct assistance in performing an examination in accordance with generally accepted auditing standards. Internal auditors may assist in performing substantive tests or tests of compliance. When the independent auditor makes such use of internal auditors, he should consider their competence and objectivity and supervise and test their work to the extent appropriate in the circumstances.

Judgments on Audit Matters

.11 When the independent auditor considers the work of internal auditors in determining the nature, timing, and extent of his own audit procedures or when internal auditors provide direct assistance in the performance of his work, judgments as to the effectiveness of internal accounting control, sufficiency of tests performed, materiality of transactions, and other matters affecting his report on the financial statements must be those of the independent auditor.

[The next page is 321-7.]

AU Section 324

Special-Purpose Reports on Internal Accounting Control at Service Organizations

Source: SAS No. 44.

See section 9324 for interpretations of this section.

Effective for examinations of financial statements for periods beginning after December 31, 1982, and for independent accountants' special-purpose reports on internal accounting control as of a date after December 31, 1982, or for a period ending after that date, unless otherwise indicated.

.01 This section provides guidance on the independent auditor's use of a special-purpose report on certain aspects of internal accounting control of an organization that provides certain services to a client whose financial statements he has been engaged to examine. (Such services are explained in paragraphs .03 and .48 "Examples of Service Organizations.") Also, this section provides guidance for independent accountants who issue such reports.¹

.02 For purposes of this section, the following definitions apply:

- *Client organization.* The entity whose financial statements are being examined.
- *User auditor.* The auditor who reports on the financial statements of the client organization.
- *Service organization.* The entity (or a segment of that entity) that provides services to the client organization.
- *Service auditor.* The auditor who reports on certain aspects of the system of internal accounting control of the service organization.

.03 The guidance in this section is applicable to the examination of the financial statements of a client organization that obtains the following services from another organization:

- Executing transactions and maintaining the related accountability
- Recording transactions and processing related data
- Various combinations of these services

¹ This section amends section 642.02 and 642.60, by adding the following footnote: "For additional guidance on reporting to another independent accountant on internal accounting control, see section 324, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*."

Service organizations that provide such services include, for example, bank trust departments that invest and hold assets for employee benefit plans and EDP service centers that process transactions and related data for others. The provisions of this section are not intended to apply to situations in which the services provided are limited to execution of client organization transactions at the specific authorization of the client, such as the processing of checking account transactions by a bank or the execution of securities transactions by a broker. However, the guidance in this section may be applied by an auditor whenever he believes obtaining a special-purpose report on aspects of internal accounting control of a service organization, as described herein, would be useful in his examination.

.04 This section is organized into the following sections:

- a. Factors affecting the decision to obtain a service auditor's report
- b. Considerations in using a service auditor's report
- c. Responsibilities of service auditors for special-purpose reports

Factors Affecting the Decision to Obtain a Service Auditor's Report

.05 When a client uses services provided by a service organization, transactions that affect the client's financial statements may flow through an accounting system that is, at least in part, physically and operationally separate from the client organization. In such circumstances, a user auditor may find it more efficient or, in some cases, necessary to consider accounting and control procedures performed at the service organization. Obtaining a service auditor's report on procedures and controls at the service organization may be the most efficient approach in those circumstances.

.06 The relationship of procedures performed at the service organization to the client organization's system depends in part on the nature of services provided by the service organization. When those services are limited to recording client transactions and processing related data, other functions relating to the flow of the transactions, such as authorization of the transaction and maintaining the related accountability, are performed at the client organization. Thus, control procedures at the service organization may interact with those at the client organization. When the service organization executes client transactions and maintains the related accountability, it may not be practicable for the client organization to maintain internal accounting controls with regard to those transactions.

Service Organizations That Maintain Controls That Interact With Client Organization Controls

.07 Client organizations may use service organizations to record various types of transactions and process related data. For example, a client organization might engage an EDP service center to process payrolls, orders, billings, collections, or specialized accounting functions such as credit card transactions, or even to maintain a general ledger system.

.08 When a service organization records transactions and provides related data processing services for a client organization, the user auditor should identify significant classes of transactions that are processed by the service organization and obtain an understanding of the flow of transactions through the entire accounting system, including the portion that is maintained by the service organization.

.09 A service auditor's report on the design of the system² used by the service organization to process client organization transactions may be helpful to the user auditor in obtaining such an understanding and in designing compliance tests and substantive tests at the client organization. Such a report, however, does not provide the user auditor with a basis for reliance on controls located at the service organization because it provides no assurance regarding compliance.³

.10 If the user auditor plans to rely on the system of internal accounting control, he should determine whether accounting control procedures are suitably designed to provide reasonable assurance that they will prevent or detect errors or irregularities, assuming satisfactory compliance. In making that determination, the user auditor should consider the division of control procedures between the client organization and the service organization.

.11 If a client organization, for example, uses an EDP service center to process payroll transactions, certain controls, such as those over input data, might be located at the client organization. Other controls, such as those over changes to the computer program used to process the payroll, would be located at the service center. The client organization might maintain controls over payroll data processed by the service center that would provide reasonable assurance that errors and irregularities in transactions processed at the service center would be detected. For example, the client organization might re-perform calculations on a test basis. In those circumstances, the user auditor would be able to plan to place reliance on internal accounting control procedures at the client organization with no further study of control procedures maintained by the service organization.

.12 In other circumstances, however, the user auditor may find that certain control procedures necessary to achieve the objectives of internal accounting control are located at the service organization. If the user auditor

² See paragraphs .28 through .35 for a description of the content of these reports.

³ If, based on past experience or for other reasons, the user auditor plans to rely on controls at the service organization, he should obtain a report that covers both the design of the system and compliance tests that are directed to specific objectives of internal accounting control.

plans to rely on such controls in designing auditing procedures to be applied in his examination of the client organization's financial statements, he should evaluate the reliance that can be placed on controls located at the service organization. Ordinarily, the user auditor can make that evaluation by either applying appropriate procedures at the service organization (or requesting the service auditor to perform procedures) or by obtaining a service auditor's report that covers both the design of the service organization's system and compliance tests that are directed to specific objectives of internal accounting control.⁴ Regardless of how the control procedures have been designed to achieve the related control objectives, the user auditor cannot place reliance on a control procedure that has not been tested and found to be applied as prescribed.

.13 If the user auditor decides to obtain a service auditor's report on both the design of the system and compliance tests that are directed to specific objectives of internal accounting control, he should consider whether the report would cover compliance with control procedures on which he intends to rely. Such a report should provide the user auditor with an understanding of the flow of transactions through the portion of the client organization's accounting system that is maintained by the service organization and the extent to which control procedures have been designed to achieve specific control objectives. Such a report also includes the service auditor's opinion as to whether the control procedures and the degree of compliance with them are sufficient to provide reasonable assurance that the specific control objectives were achieved. If the user auditor finds that the service auditor's report would not cover the procedures on which he intends to rely, he may arrange to have the service auditor report on the results of applying agreed-upon procedures for testing compliance with the control procedures on which he intends to rely or he may perform his own compliance tests at the service organization.

.14 After obtaining the service auditor's report, the user auditor should consider whether the combination of internal accounting control procedures at the client organization and the service organization provides a basis for reliance in restricting the extent of substantive tests. Relevant control weaknesses in the service organization's system should be considered weaknesses in the client organization's system. If the report of the service auditor discloses weaknesses either in the design of the portion of the service organization's system of internal accounting control related to processing of client organization transactions or the extent of compliance with prescribed procedures, the user auditor should assess the effect of such weaknesses on the nature, timing, or extent of substantive tests.

⁴ See paragraphs .28 and .29 and .36 through .41 for a description of the content of these reports.

Service Organizations That Maintain Controls That Do Not Interact With Client Organization Controls

.15 Certain service organizations execute transactions and maintain the related accountability. Examples of such service organizations include trustees of employee benefit plans that invest and hold assets for the plans, mortgage bankers and savings and loan associations that service loans for others, and organizations that perform shareowner accounting services for open-end investment companies.

.16 If the service organization is authorized by the client organization to execute transactions without specific authorization of individual transactions, the client organization may not have independent records of the transactions executed by the service organization and, accordingly, will not be able to maintain controls to achieve the objectives of internal accounting control with respect to those transactions. For example, when a bank trust department invests and holds assets for an employee benefit plan under a discretionary trust arrangement, the plan is not able to maintain an independent record of transactions executed by the trust department. As a result, the plan is not able to maintain controls that achieve the objectives of internal accounting control with respect to transactions executed by the trust department. In such circumstances, the user auditor will need to either rely on internal accounting controls at the service organization or apply substantive tests at the service organization.

.17 If the service organization executes transactions only on the specific authorization of the client organization, the client organization will be able to maintain independent records of transactions executed by the service organization and will normally be able to maintain controls to achieve the objectives of internal accounting control with respect to those transactions. An example of a service organization that executes transactions only on the specific authorization of the client organization is a bank trust department that invests and holds assets for an employee benefit plan under a nondiscretionary or directed trust arrangement. However, in such circumstances, the user auditor might still find it more efficient to restrict substantive tests by relying on controls at the service organization.

.18 If the user auditor intends to rely on internal accounting controls at the service organization in either of the circumstances described in paragraph .16 or .17, he should do one of the following to meet the objectives of his study and evaluation of internal accounting control as described in section 320 (see Appendix G):

- Obtain a service auditor's opinion on the system of internal accounting control of the segment of the service organization that executes client organization transactions,⁵ or, if such a segment of the service organization is not distinguishable,⁶ a service auditor's report that covers both the design of the service organization's system and

⁵ See paragraphs .42 through .46 for a description of the content of these reports. A service auditor's report on the internal accounting controls applied by the segment of a service organization that executes client organization transactions should include an opinion on that system of internal accounting control, taken as a whole, over a period of time.

⁶ Section 642.37, states that "an independent accountant may express an opinion on a system of internal accounting control of an entity for which financial statements in accordance with generally accepted accounting principles, or any other criteria applicable to such statements, can be prepared." When the "entity" is a segment, the primary concern in applying the criteria of that paragraph is that the assets and activities of the segment can be clearly distinguished, physically and operationally, and for financial reporting purposes, from the other assets and activities of the organization.

compliance tests that are directed to specific objectives of internal accounting control.

- Apply auditing procedures at the service organization to make a study of the relevant internal accounting control procedures.

If the user auditor decides to make either compliance or substantive tests at the service organization, he may request the service auditor to make the tests or he may make such tests himself.

Considerations in Using a Service Auditor's Report

.19 There are several considerations that apply if a user auditor has decided to obtain a service auditor's special-purpose report on internal accounting control.

Obtaining and Evaluating a Service Auditor's Report

.20 The user auditor should contact the service organization through the client organization to determine whether a service auditor's report on the service organization's internal accounting controls is available and, if so, the type of report that is available. If no report is to be issued, or the report to be issued is not appropriate for the user auditor's purposes and the user auditor cannot influence the decision on the type of report to be issued, he may have to apply procedures at the service organization to achieve his audit objectives or request the service auditor to apply the procedures.

.21 In evaluating whether the service auditor's report is satisfactory for his purposes, the user auditor should make inquiries concerning the service auditor's professional reputation. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in section 543.10a.

.22 If the user auditor believes that the service auditor's report may not be sufficient to meet his objectives, the user auditor may supplement his understanding of the service auditor's procedures and conclusions by discussing with the service auditor the scope and the results of his work. Also, if he believes it is necessary, the user auditor may request the service auditor to make specific tests of the service organization's records that apply particularly to the type of transactions processed by the service organization for his client or he may make such tests himself. If the user auditor is unable to achieve his audit objectives, he should qualify his opinion or disclaim an opinion on the financial statements because of a scope limitation.

Timing of Service Auditor's Report

.23 The date or period covered by a service auditor's report may not coincide with the period covered by the financial statements that the user auditor has been engaged to examine. In some situations, the service organization might engage the service auditor to issue reports periodically throughout the year, for example, at the end of each calendar quarter. The user auditor should consider the guidance provided by section 320.70 (see Appendix G) (as amended by Statement on Auditing Standards No. 43, *Omnibus Statement on Auditing Standards*) in deciding whether tests of compliance need to be applied to the period from the date of the service auditor's last report to his client's year-end. The user auditor's inquiries concerning the period since the date of the service auditor's last report should include inquiring of the service auditor or the service organization concerning any significant subsequent changes in internal accounting controls and, if the user auditor determines it is

necessary, requesting additional procedures. [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

Reference to a Service Auditor's Report

.24 In reporting on his examination of the financial statements, the user auditor should not make reference to the report of the service auditor as a basis, in part, for his own opinion. The service auditor's report is used in the examination, but the service auditor is not responsible for examining a portion of the financial statements as of any specific date or for any specified period of time. Thus, there cannot be a meaningful indication of a division of responsibility for the financial statements.

.25 If the user auditor uses the service auditor's report in an engagement to express an opinion on his client's system of internal accounting control, the user auditor may decide to refer to the service auditor's report in accordance with the guidance given in section 642.45. In this case, the portion of the system that is the responsibility of the service auditor can be specifically identified.

Responsibilities of Service Auditors for Special-Purpose Reports

.26 The service auditor is responsible for the representations in his report to user auditors and for due care in the application of procedures that support those representations. Although the nature of his service differs from an examination of financial statements in accordance with generally accepted auditing standards, it should be performed in accordance with the general standards and those other standards that are relevant. However, it is neither necessary nor practical to require the service auditor to be independent with regard to each client organization.

.27 The type of engagement to be performed and the type of report to be prepared should be established by the service organization. However, if circumstances permit, discussions between the service organization and client organizations are advisable to determine the type of report that will be most suitable for the client organizations' needs. The service auditor may issue any of the following types of reports:

- a. *Reports on the design of the system.* A report on the design of a system of internal accounting control of a service organization may be useful in providing a user auditor with an understanding of the system and the relationship of the service organization's controls to those of client organizations. Such reports may also be useful in designing compliance tests and substantive tests at the client organization, but they do not provide the user auditor with a basis for reliance on controls located at the service organization.
- b. *Reports on both the design of the system and compliance tests that are directed to specific objectives of internal accounting control.* These reports may also be useful in providing a user auditor with an understanding of the system and the relationship of the service organization's controls to those of client organizations. Such reports may also provide a basis for the user auditor to rely on the service organization's internal accounting controls and may be useful in designing compliance tests and substantive tests at the client organization.

- c. *Reports on the system of a segment of the service organization.* These reports do not ordinarily include a description of the design of the system of the service organization. Such reports may be useful when it is unlikely that client organizations will maintain controls that interact with those of the service organization, for example, when the service organization executes transactions and maintains accountability for assets owned by others.

The system referred to in the reports described above is the system used by the service organization to process client organization transactions rather than the system of internal accounting control relevant to the preparation of the service organization's financial statements.

Reports on Design and on Both Design and Certain Compliance Tests

.28 Section 642, *Reporting on Internal Accounting Control*, paragraphs .60 and .61, provide general guidance on the preparation of special-purpose reports on internal accounting control, including reports for use by another independent accountant.

.29 Section 642 states that special-purpose reports on internal accounting control should—

- a. Describe the scope and nature of the accountant's procedures.
- b. Disclaim an opinion on whether the system, taken as a whole, meets the objectives of internal accounting control.
- c. State the accountant's findings.
- d. Indicate that the report is intended solely for management or specified third parties.

This section provides additional guidance on particular types of special-purpose reports.

.30 Reports on the Design of a System. The information required for the service auditor's report on the design of a system ordinarily is obtained through discussion with appropriate service organization personnel and reference to various forms of documentation such as systems flowcharts and narratives. These procedures need not be supplemented by tests of compliance. To enhance his understanding of the information obtained from such sources, however, the service auditor would ordinarily trace a limited number of transactions, for each of the principal types of transactions, by examining supporting documents and records maintained and by making observations and corroborative inquiries at or near the date specified in the report.

.31 A service auditor's report on the design of the system includes his opinion on the design of the system as of a specified date. Therefore, the service auditor is not required to specifically search or test for changes in the system that may have occurred before the beginning of fieldwork. In the course of the review, however, the service auditor may become aware that such changes have occurred. If the service auditor believes the changes may be significant to achieving control objectives he has identified, the changes should be described in his report. Changes that occurred more than twelve months before the date being reported on normally would not be considered significant because they generally would not affect the user auditor's procedures.

.32 If the service auditor notes circumstances in reviewing the design of a system that lead him to believe that certain control objectives are not achieved, his report should describe those conditions. Such conditions might include control procedures that have been described by the service organization as existing, but that are not present, as well as control procedures that are not included in the design but that, in the judgment of the service auditor, are necessary to achieve a control objective.

.33 In addition to the elements of special-purpose reports described in section 642.61, the service auditor's report on the design of a system should—

- Include a description of the system used by the service organization to process client organization transactions and the related internal accounting control procedures that are relevant to the client organizations.
- Include a description of the specific control objectives that relate to points in the flow of transactions where errors or irregularities could occur and the specific control procedures that are designed to achieve those objectives for each significant accounting application.
- State that the purpose of the procedures performed was to evaluate the design of the control procedures and that the service auditor did not test for compliance with the described control procedures.
- State the inherent limitations of any system of internal accounting control and the risk of projection of an evaluation to future periods.
- State the service auditor's opinion as to whether the control procedures described were suitably designed to provide reasonable, but not absolute, assurance that the control objectives specified

would be achieved if the control procedures were complied with satisfactorily.

.34 The description of the system required for these reports may be prepared by the service organization and included in an attachment to which the service auditor's report refers. If the service auditor prepares the necessary description of the system, the representations in the description remain the responsibility of the service organization.

.35 The following illustrative report is considered appropriate when an auditor reports on the design of internal accounting controls maintained by a service organization, in this example, an EDP service center. The report assumes that the description of operations and control procedures is divided into two sections: Section 1 is the service organization's description of the system; section 2 lists specific control objectives and describes control procedures that achieve those objectives. This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

To the Blank Service Center:

We have reviewed the accompanying description of the operations and control procedures of the Blank Service Center related to its payroll processing system as of (date) and identified specific control objectives and the procedures that achieve those objectives. Our review included procedures we considered necessary in the circumstances to evaluate the design of the control procedures specified in section 2. We did not test compliance with the control procedures and, accordingly, we do not express an opinion on whether those controls were being applied as prescribed for any period of time or on whether the system, taken as a whole, meets the objectives of internal accounting control. A further description of our review and its objections is attached.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions.

In our opinion, the control procedures included in the accompanying description of the payroll processing system of the Blank Service Center as of (date) are suitably designed to provide reasonable, but not absolute, assurance that the control objectives specified in section 2 would be achieved if the control procedures were complied with satisfactorily.

This report is intended solely for use by management of Blank Service Center, its customers, and the independent auditors of its customers.

.36 *Reports on Both the Design of a System and Certain Compliance Tests.* The information necessary for a service auditor's report that covers both the design of a system and compliance tests that are directed to specific objectives of internal accounting control ordinarily is obtained through discussion with appropriate service organization personnel, reference to

various forms of documentation such as system flowcharts and narratives, tests of compliance with specific control procedures, and other means of investigation. Section 350, *Audit Sampling*, provides guidance for the application and evaluation of audit sampling in testing compliance with internal accounting controls.

.37 If the service auditor notes circumstances in reviewing the design of the system or in his tests of compliance that lead him to believe that certain control objectives are not achieved, his report should describe those conditions. Such conditions might include control procedures that have been described by the service organization as existing, but that are not present or are not being adhered to, as well as control procedures that are not included in the system but that, in the service auditor's judgment, are necessary to achieve a control objective.

.38 A service auditor's report on both the design of the system and certain compliance tests will not necessarily include a list of each compliance deviation or error found in the records during his tests. The service auditor's discovery of deviations relating to transactions processed for others will not necessarily preclude him from reaching a conclusion that a system's objectives were achieved if he believes the rate of occurrence of deviations is not significant in relation to the number of records examined, or if occurrences have been detected and corrected in the normal functioning of the system.

.39 In addition to the elements of special-purpose reports described in section 642.61, the service auditor's report on both the design of a system and compliance tests that are directed to specific objectives of internal accounting control should—

- Include a description of the system used by the service organization to process client organization transactions and the related internal accounting control procedures that are relevant to the client organizations.
- Include a description of the specific control objectives that relate to points in the flow of transactions where errors or irregularities could occur and the specific control procedures that are designed to achieve those objectives for each significant accounting application.
- State the inherent limitations of any system of internal accounting control and the risk of projection of an evaluation to future periods.
- State the service auditor's opinion as to whether control procedures and the degree of compliance with them were sufficient to provide reasonable, but not absolute, assurance that specific control objectives were achieved during the time period covered by the review.

.40 The description of the system required for these reports may be prepared by the service organization and included in an attachment to which the service auditor's report refers. If the service auditor prepares the necessary description of the system, the representations in the description remain the responsibility of the service organization.

.41 The following illustrative report is considered appropriate when an auditor reports on the design of, and compliance with, certain internal

accounting control procedures maintained by a service organization, in this example, an EDP service center. The report assumes that the description of operations and control procedures is divided into two sections: Section 1 is the service organization's description of the system; section 2 lists specific control objectives and describes control procedures that achieve those objectives. This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

To the Blank Service Center:

We have reviewed the accompanying description of the operations and control procedures of the Blank Service Center related to its payroll processing system and identified specific control objectives and the procedures that achieve those objectives. Our review, covering the period from (date) to (date), included such tests as we considered necessary to evaluate whether the procedures described in section 2 and the extent of compliance with them are sufficient to provide reasonable, but not absolute, assurance that the control objectives specified therein were achieved. We tested compliance only with the control procedures listed in section 2. Accordingly, we do not express an opinion on whether all of the controls described in section 1 were being applied as prescribed for any period of time or on whether the system, taken as a whole, meets the objectives of internal accounting control. A further description of our review and its objectives is attached.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the degree of compliance with the procedures may deteriorate.

In our opinion, the control procedures of the Blank Service Center payroll processing system described in section 2 and the degree of compliance with them were sufficient to provide reasonable, but not absolute, assurance that the control objectives specified therein were achieved for the period from (date) to (date).

This report is intended solely for use by management of Blank Service Center, its customers, and the independent auditors of its customers.

Reports on the System of a Segment of the Service Organization

.42 A service auditor's report on the system of a segment of the service organization that executes transactions for others includes the service auditor's opinion on the internal accounting controls applied by the segment to the execution and recording of those transactions. Guidance for preparing reports that express an opinion on an entity's system of internal accounting control is provided by section 642.03 through 642.46.

.43 The form of opinion on a system of internal accounting control specified in section 642 is that the system taken as a whole was sufficient to meet the objectives of internal accounting control "insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the [entity's] financial statements." In reporting on the internal accounting controls applied by a segment of a service organization that executes transactions for others, the basis for assessing the materiality of potential errors or irregularities is the financial statements of the service organization rather than the segment because the relationship of potential errors and irregularities to the segment's financial position is not meaningful.

.44 A service auditor's report on the system of a segment of the service organization will not necessarily include a list of each compliance deviation or error found in the records during his tests. The service auditor's discovery of deviations relating to transactions processed for others will not necessarily preclude him from reaching a conclusion that a system's objectives were achieved if he believes the rate of occurrence of deviations is not significant in relation to the number of records examined or if occurrences have been detected and corrected in the normal functioning of the system.

.45 Even though the specific errors or irregularities detected or the conditions that permitted them may not be significant to his overall evaluation, the service auditor should consider the appropriateness of the actions taken by management to correct such matters. If the service auditor believes that errors (including differences between the records and the reports submitted by the service organization to the client organization) would be material to the assets held for an affected client organization, or if he detects irregularities, he should request that the service organization report them to the client organization. If the service organization does not report the errors or irregularities to the client organization, the service auditor should describe them in his report.

.46 The following language should be used to express an unqualified opinion on a system of internal accounting control of a segment of a service organization, in this example, the trust department of a bank. This report is a standard form and should be supplemented as appropriate to suit the circumstances of individual engagements.

To the Blank Bank and Trust Company:

We have made a study and evaluation of the system of internal accounting control of the trust department of Blank Bank and Trust Company that existed during the period from (date) to (date), which department has responsibility for personal, custodial, and corporate trust accounts. Our study and evaluation was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

The management of Blank Bank and Trust Company is responsible for establishing and maintaining a system of internal accounting control. In

fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of such a system are to provide management with reasonable, but not absolute, assurance that assets for which the trust department has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and in conformity with the governing instruments and are recorded properly to permit the preparation of the required financial reports.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

In our opinion, the system of internal accounting control of the trust department of Blank Bank and Trust Company that existed during the period from (date) to (date), taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the financial statements of Blank Bank and Trust Company.⁷

Effective Date

.47 This section is effective for examinations of financial statements for periods beginning after December 31, 1982, and for independent accountants' special-purpose reports on internal accounting control as of a date after December 31, 1982, or for a period ending after that date. Earlier application is encouraged.

⁷ This report is prepared in conformity with the requirements of section 642.02a; therefore, restriction of its use is not necessary.

Appendix

.48 Examples of Service Organizations

The following description of service organizations is intended to be illustrative and is not all-inclusive.

- *Service centers that provide data processing functions for other organizations.* Service centers offer a range of services, including providing time-shared computer services, processing standard program packages, and designing and processing tailored systems. The service center may specialize in a particular application, such as payroll or inventory, or in a particular industry, such as securities brokerage or savings and loan. A service center that processes for different customers similar applications using the same computer programs, which have a significant effect on the financial data of each of its users, could be the subject of a study and evaluation of internal accounting control by a service auditor. For additional information on service centers, see the AICPA Audit Guide, *Audits of Service-Center-Produced Records*.
- *Insurers that maintain the accounting for ceded reinsurance.* Reinsurance is the assumption by one insurer of all or part of a risk originally undertaken by another insurer. The independent auditor of the assuming company, as an alternative procedure, may obtain a report on internal accounting control related to ceded reinsurance from the ceding company's independent auditor. For additional information, see the Statement of Position, *Auditing Property and Liability Reinsurance*.
- *Trust departments of banks or similar entities.* A formal trust agreement may be executed by the administrator of an employee benefit plan or a trust with a bank or insurance company as trustee. Generally, a bank acting as trustee is also custodian of those investments under its control. In addition, the trust agreements may provide for discretionary or nondiscretionary control over trust assets. A discretionary trust gives the trustee authority to purchase or sell trust assets within the framework of the trust agreement. A nondiscretionary trust (or "directed trust") allows the trustee to purchase or sell trust assets only at the direction of the party named as having discretion, such as an administrator, investment committee, or investment advisor. A bank trust department may engage an independent auditor to perform a study and evaluation of the trust department's internal accounting controls and issue a report setting forth the scope of the review and the accountant's opinion on the system. This report would then be available to the auditors of the employee benefit plans and the trusts. For additional information concerning the audits of employee benefit plans, see the AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*.
- *Mortgage bankers or savings and loan associations that service loans for others.* Some organizations purchase mortgage loans, or participation interests in such loans, from savings and loan associations, banks, or mortgage companies. The seller continues to service the loans, but the loans are not assets of the service organization. The

service organization's independent auditor may issue a report confirming the extent to which his examination included confirmation and other procedures for such loans and the results. For additional information on mortgage loans, see the AICPA Industry Audit Guide, *Savings and Loan Associations*, rev. ed.

- *Shareowner accounting organizations for investment companies.* Open-end investment companies generally use banks or other independent organizations to act as shareowner accounting organizations. Those organizations process and record in individual shareowner accounts transactions in capital shares of investment companies, including sales, redemptions and transfers of such capital shares, and payment or reinvestment of dividends. Those transactions are usually initiated by investors directly with the shareowner accounting organization, which generally also acts as a transfer agent for the investment company. The independent auditor of an investment company may request a report on the internal accounting control of the bank or other organization that performs those functions. For additional information concerning audits of investment companies, see the AICPA Industry Audit Guide, *Audits of Investment Companies*.
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AU Section 325***Communication of Internal Control
Structure Related Matters
Noted in an Audit***

(Supersedes AU sections 323 and 642.47—.53 [See Appendix G])

Source: SAS No. 60.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section provides guidance in identifying and reporting conditions that relate to an entity's internal control structure observed during an audit of financial statements. It is contemplated that the communication would generally be to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, such as the board of directors, the board of trustees, an owner in an owner-managed enterprise, or others who may have engaged the auditor. For the purpose of this section, the term *audit committee* is used to refer to the appropriate recipient of the communication. This section also provides guidance on establishing, between the auditor and client, agreed-upon criteria for identifying and reporting additional matters beyond those required by this section.

Reportable Conditions

.02 During the course of an audit, the auditor may become aware of matters relating to the internal control structure that may be of interest to the audit committee. The matters that this section requires for reporting to the audit committee are referred to as *reportable conditions*.¹ Specifically, these are matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.² Such deficiencies may involve aspects of the internal control structure elements of (a) the control environment, (b) the accounting system, or (c) control procedures. (See paragraph .21, for examples of reportable conditions.)

¹ This section supersedes section 323, *Required Communication of Material Weaknesses in Internal Accounting Control* (See Appendix G), and section 642, *Reporting on Internal Accounting Control*, paragraphs .47 through .53 (See Appendix G), and related auditing interpretations. This section does not affect the reporting of material weaknesses noted in an engagement to report on an entity's internal control structure.

² The auditor should also consider matters coming to his attention that relate to interim financial reporting outside the entity in the communication contemplated by this section.

.03 The auditor may also identify matters that, in his judgment, are not reportable conditions as defined in paragraph .02; however, the auditor may choose to communicate such matters for the benefit of management (and other recipients, as appropriate).

Identifying Reportable Conditions

.04 The auditor's objective in an audit of financial statements is to form an opinion on the entity's financial statements taken as a whole. The auditor is not obligated to search for reportable conditions. However, the auditor may become aware of possible reportable conditions through consideration of the elements of the internal control structure,³ application of audit procedures to balances and transactions, or otherwise during the course of the audit. The auditor's awareness of reportable conditions varies with each audit and is influenced by the nature and extent of audit procedures and numerous other factors, such as an entity's size, its complexity, and the nature and diversity of its business activities.

.05 In making the judgment as to which matters are reportable conditions, the auditor should take into consideration various factors relating to the entity, such as its size, complexity and diversity of activities, organizational structure, and ownership characteristics.

.06 The existence of reportable conditions related to internal control structure design or operation may already be known and, in fact, may represent a conscious decision by management—a decision of which the audit committee is aware—to accept that degree of risk because of cost or other considerations. It is the responsibility of management to make the decisions concerning costs to be incurred and related benefits. Provided the audit committee has acknowledged its understanding and consideration of such deficiencies and the associated risks, the auditor may decide the matter does not need to be reported. Periodically, the auditor should consider whether, because of changes in management, the audit committee, or simply because of the passage of time, it is appropriate and timely to report such matters.

Agreed-Upon Criteria

.07 The auditor and client may discuss the internal control structure and concerns regarding its functioning when making arrangements for the audit. Clients may request the auditor to be alert to matters and to report conditions that go beyond those contemplated by this section. The auditor is not precluded from reporting matters that he views to be of value to management in the absence of any specific request to do so.

.08 Agreed-upon arrangements between the auditor and the client to report conditions noted may include, for example, the reporting of matters of less significance than provided for by this section, the existence of conditions specified by the client, or the results of further investigation of matters noted to identify underlying causes. Under these arrangements, it is possible that the auditor may be requested to visit specific locations, assess specific control procedures, or undertake specific procedures not otherwise planned.

³ The *internal control structure* refers to the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. (See section 319, *Consideration of the Internal Control Structure in a Financial Statement Audit*, for additional key definitions.)

Reporting—Form and Content

.09 Conditions noted by the auditor that are considered reportable under this section or that are the result of agreement with the client should be reported, preferably in writing. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers.

.10 The report should state that the communication is intended solely for the information and the use of the audit committee, management, and others within the organization. When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory authorities may be made.

.11 Any report issued on reportable conditions should—

- Indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure.
- Include the definition of reportable conditions.
- Include the restriction on distribution as discussed in paragraph .10.

.12 The following is an illustration of the sections of a report encompassing the above requirements.

In planning and performing our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[Include paragraphs to describe the reportable conditions noted.]

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency or other specified third party).

.13 In some circumstances, the auditor may wish to include additional statements in the report regarding the inherent limitations of the internal control structure in general, the specific extent and nature of his consideration of the internal control structure during the audit, or other matters regarding the basis for the comments made.

.14 In a communication that contains both observations deemed by the auditor to be reportable conditions, as defined, and other comments, it may be appropriate to indicate which comments are in each category.

.15 A reportable condition may be of such magnitude as to be considered a material weakness. A *material weakness* in the internal control structure is a reportable condition in which the design or operation of the specific internal control structure elements do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned

functions. Although this section does not require that the auditor separately identify and communicate material weaknesses, the auditor may choose or the client may request the auditor to separately identify and communicate as material weaknesses those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses.

.16 The following is an illustration of the sections of a report that may be used when the auditor wishes, or has been requested, to advise the audit committee in writing that one or more reportable conditions have been identified, but none is deemed to be a material weakness.

[Include the first paragraph in the report illustrated in paragraph .12.]

[Include paragraphs to describe the reportable conditions noted.]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above is believed to be a material weakness.

[Include the final paragraph in the report illustrated in paragraph .12.]

.17 Because of the potential for misinterpretation of the limited degree of assurance associated with the auditor issuing a written report representing that no reportable conditions were noted during an audit, the auditor should not issue such representations.

.18 Because timely communication may be important, the auditor may choose to communicate significant matters during the course of the audit rather than after the audit is concluded. The decision on whether an interim communication should be issued would be influenced by the relative significance of the matters noted and the urgency of corrective follow-up action.

.19 The provisions in this section should not be viewed as precluding an auditor from communicating to a client a variety of observations and suggestions regarding its activities that go beyond internal control structure related matters. Such matters may deal with operational or administrative efficiencies, business strategies, and other items of perceived benefit to the client.

Effective Date

.20 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989, with early application permissible.

Appendix

.21 Examples of Possible Reportable Conditions

1. As indicated in paragraph .02 of this section reportable conditions involve matters coming to the auditor's attention that relate to significant deficiencies in the design or operation of the internal control structure that, in the auditor's judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

2. The following are examples of matters that may be reportable conditions. They are grouped by categories of conditions and within categories by specific examples of conditions. Certain of these matters may also require communications under the provisions of other statements on auditing standards.

Deficiencies in internal control structure design

- Inadequate overall internal control structure design
- Absence of appropriate segregation of duties consistent with appropriate control objectives
- Absence of appropriate reviews and approvals of transactions, accounting entries, or systems output
- Inadequate procedures for appropriately assessing and applying accounting principles
- Inadequate provisions for the safeguarding of assets
- Absence of other control techniques considered appropriate for the type and level of transaction activity
- Evidence that a system fails to provide complete and accurate output that is consistent with objectives and current needs because of design flaws

Failures in the operation of the internal control structure

- Evidence of failure of identified controls in preventing or detecting misstatements of accounting information
- Evidence that a system fails to provide complete and accurate output consistent with the entity's control objectives because of the misapplication of control procedures
- Evidence of failure to safeguard assets from loss, damage or misappropriation
- Evidence of intentional override of the internal control structure by those in authority to the detriment of the overall objectives of the system
- Evidence of failure to perform tasks that are part of the internal control structure, such as reconciliations not prepared or not timely prepared
- Evidence of willful wrongdoing by employees or management
- Evidence of manipulation, falsification, or alteration of accounting records or supporting documents
- Evidence of intentional misapplication of accounting principles

- Evidence of misrepresentation by client personnel to the auditor
- Evidence that employees or management lack the qualifications and training to fulfill their assigned functions

Others

- Absence of a sufficient level of control consciousness within the organization
 - Failure to follow up and correct previously identified internal control structure deficiencies
 - Evidence of significant or extensive undisclosed related party transactions
 - Evidence of undue bias or lack of objectivity by those responsible for accounting decisions
-

[The next page is 321-33.]

AU Section 326

Evidential Matter

(Supersedes section 330, "Evidential Matter")

Sources: SAS No. 31; SAS No. 48.

See section 9326 for interpretations of this section.

Issue date, unless otherwise indicated: August, 1980.

.01 The third standard of field work is:

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

.02 Most of the independent auditor's work in forming his opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. The measure of the validity of such evidence for audit purposes lies in the judgment of the auditor; in this respect audit evidence differs from legal evidence, which is circumscribed by rigid rules. Evidential matter varies substantially in its influence on the auditor as he develops his opinion with respect to financial statements under examination. The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.

Nature of Assertions

.03 Assertions are representations by management that are embodied in financial statement components. They can be either explicit or implicit and can be classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

.04 Assertions about existence or occurrence deal with whether assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period. For example, management asserts that finished goods inventories in the balance sheet are available for sale. Similarly, management asserts that sales in the income statement represent the exchange of goods or services with customers for cash or other consideration.

.05 Assertions about completeness deal with whether all transactions and accounts that should be presented in the financial statements are so included. For example, management asserts that all purchases of goods and services are recorded and are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.

.06 Assertions about rights and obligations deal with whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. For example, management asserts that amounts capitalized for leases in the balance sheet represent the cost of the entity's rights to leased property and that the corresponding lease liability represents an obligation of the entity.

.07 Assertions about valuation or allocation deal with whether asset, liability, revenue, and expense components have been included in the financial statements at appropriate amounts. For example, management asserts that property is recorded at historical cost and that such cost is systematically allocated to appropriate accounting periods. Similarly, management asserts that trade accounts receivable included in the balance sheet are stated at net realizable value.

.08 Assertions about presentation and disclosure deal with whether particular components of the financial statements are properly classified, described, and disclosed. For example, management asserts that obligations classified as long-term liabilities in the balance sheet will not mature within one year. Similarly, management asserts that amounts presented as extraordinary items in the income statement are properly classified and described.

Use of Assertions in Developing Audit Objectives and Designing Substantive Tests

.09 In obtaining evidential matter in support of financial statement assertions, the auditor develops specific audit objectives in the light of those assertions. In developing the audit objectives of a particular engagement, the auditor should consider the specific circumstances of the entity, including the nature of its economic activity and the accounting practices unique to its industry. For example, one audit objective related to the assertion about completeness that an auditor might develop for inventory balances is that inventory quantities include all products, materials, and supplies on hand.

.10 There is not necessarily a one-to-one relationship between audit objectives and procedures. Some auditing procedures may relate to more than one objective. On the other hand, a combination of auditing procedures may be needed to achieve a single objective. Paragraph .48 provides illustrative audit objectives for inventories of a manufacturing company for each of the broad categories of assertions listed in paragraph .03 and examples of substantive tests that may achieve those audit objectives.

.11 In selecting particular substantive tests to achieve the audit objectives he has developed, an auditor considers, among other things, the extent of reliance, if any, to be placed on internal accounting control, the relative risk of errors or irregularities that would be material to financial statements, and the expected effectiveness and efficiency of such tests. His considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved. For example, in designing substantive tests to achieve an objective related to the assertion of existence or occurrence, the auditor selects from items contained in a financial statement amount and searches for relevant evidential matter. On the other hand, in designing procedures to achieve an objective related to the assertion of completeness, the auditor selects from evidential matter indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included.

.12 The auditor's specific audit objectives do not change whether accounting data is processed manually or by computer. However, the methods of

applying audit procedures to gather evidence may be influenced by the method of data processing. The auditor can use either manual audit procedures, computer-assisted audit techniques, or a combination of both to obtain sufficient, competent evidential matter. However, in some accounting systems that use a computer for processing significant accounting applications, it may be difficult or impossible for the auditor to obtain certain data for inspection, inquiry, or confirmation without computer assistance. [New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.13 The nature, timing, and extent of the procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor, based on the specific circumstances. However, the procedures adopted should be adequate to achieve the audit objectives developed by the auditor, and the evidential matter obtained should be sufficient for the auditor to form conclusions concerning the validity of the individual assertions embodied in the components of financial statements. The combination of the auditor's reliance on internal accounting control and on selected substantive tests should provide a reasonable basis for his opinion (see section 320.82 in Appendix G). [Reference changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, paragraph .12 renumbered and reference changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Nature of Evidential Matter

.14 Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor. [Formerly paragraph .13, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.15 The books of original entry, the general and subsidiary ledgers, related accounting manuals, and such informal and memorandum records as work sheets supporting cost allocations, computations, and reconciliations all constitute evidence in support of the financial statements. By itself, accounting data cannot be considered sufficient support for financial statements; on the other hand, without adequate attention to the propriety and accuracy of the underlying accounting data, an opinion on financial statements would not be warranted. [Formerly paragraph .14, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.16 Corroborating evidential matter includes documentary material such as checks, invoices, contracts, and minutes of meetings; confirmations and other written representations by knowledgeable people; information obtained by the auditor from inquiry, observation, inspection, and physical examination; and other information developed by, or available to, the auditor which permits him to reach conclusions through valid reasoning. [Formerly paragraph .15, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.17 The auditor tests underlying accounting data by analysis and review, by retracing the procedural steps followed in the accounting process and in developing the work sheets and allocations involved, by recalculation, and by reconciling related types and applications of the same information. In a soundly conceived and carefully maintained system of accounting records, there is internal consistency discoverable through such procedures that constitutes persuasive evidence that the financial statements do present financial

position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. [Formerly paragraph .16, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.18 The pertinent documentary material to support entries in the accounts and assertions in the financial statements ordinarily is on hand in the company's files and available to the auditor for examination. Both within the company's organization and outside it are knowledgeable people to whom the auditor can direct inquiries. Assets having physical existence are available to the auditor for his inspection. Activities of company personnel can be observed. Based on certain conditions as he observes them, conditions of internal accounting control for example, he can reason to conclusions with respect to the validity of various assertions in the financial statements. [Formerly paragraph .17, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Competence of Evidential Matter

.19 To be competent, evidence must be both valid and relevant. The validity of evidential matter is so dependent on the circumstances under which it is obtained that generalizations about the reliability of various types of evidence are subject to important exceptions. If the possibility of important exceptions is recognized, however, the following presumptions, which are not mutually exclusive, about the validity of evidential matter in auditing have some usefulness:

- a. When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity.
- b. When accounting data and financial statements are developed under satisfactory conditions of internal accounting control, there is more assurance about their reliability than when they are developed under unsatisfactory conditions of internal accounting control.
- c. The independent auditor's direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.

[Formerly paragraph .18, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Sufficiency of Evidential Matter

.20 The independent auditor's objective is to obtain sufficient competent evidential matter to provide him with a reasonable basis for forming an opinion. The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his professional judgment after a careful study of the circumstances in the particular case. In the great majority of cases, the auditor finds it necessary to rely on evidence that is persuasive rather than convincing. Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles, are of such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being

examined. [Formerly paragraph .19, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.21 An auditor typically works within economic limits; his opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost. The auditor must decide, again exercising professional judgment, whether the evidential matter available to him within the limits of time and cost is sufficient to justify expression of an opinion. [Formerly paragraph .20, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.22 As a guiding rule, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. In determining the usefulness of evidence, relative risk may properly be given consideration. The matter of difficulty and expense involved in testing a particular item is not in itself a valid basis for omitting the test. [Formerly paragraph .21, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Evaluation of Evidential Matter

.23 In evaluating evidential matter, the auditor considers whether specific audit objectives have been achieved. The independent auditor should be thorough in his search for evidential matter and unbiased in its evaluation. In designing audit procedures to obtain competent evidential matter, he should recognize the possibility that the financial statements may not be presented in conformity with generally accepted accounting principles. In developing his opinion, the auditor should give consideration to relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. To the extent the auditor remains in substantial doubt about any assertion of material significance, he must refrain from forming an opinion until he has obtained sufficient competent evidential matter to remove such substantial doubt, or he must express a qualified opinion or a disclaimer of opinion. [Formerly paragraph .22, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Appendix

.24 Financial Statement Assertions, Illustrative Audit Objectives, and Examples of Substantive Tests

Illustrations for Inventories of a Manufacturing Company

This appendix illustrates the use of assertions in developing audit objectives and designing substantive tests. The following examples of substantive tests are not intended to be all-inclusive nor is it expected that all of the procedures would be applied in an examination.

Illustrative Audit Objectives

Examples of Substantive Tests

Existence or Occurrence

Inventories included in the balance sheet physically exist

- Observing physical inventory counts.
- Obtaining confirmation of inventories at locations outside the entity.
- Testing of inventory transactions between a preliminary physical inventory date and the balance sheet date.

Inventories represent items held for sale or use in the normal course of business.

- Reviewing perpetual inventory records, production records, and purchasing records for indications of current activity.
- Comparing inventories with a current sales catalog and subsequent sales and delivery reports.
- Using the work of specialists to corroborate the nature of specialized products.

Completeness

Inventory quantities include all products, materials, and supplies on hand.

- Observing physical inventory counts.
- Analytically reviewing the relationship of inventory balances to recent purchasing, production, and sales activities.
- Testing shipping and receiving cutoff procedures.

Inventory quantities include all products, materials, and supplies owned by the company that are in transit or stored at outside locations.

- Obtaining confirmation of inventories at locations outside the entity.
- Analytically reviewing the relationship of inventory balances to recent purchasing, production, and sales activities.
- Testing shipping and receiving cutoff procedures.

Illustrative Audit Objectives

Inventory listings are accurately compiled and the totals are properly included in the inventory accounts.

Examples of Substantive Tests

- Testing shipping and receiving cutoff procedures.
- Tracing test counts recorded during the physical inventory observation to the inventory listing.
- Accounting for all inventory tags and count sheets used in recording the physical inventory counts.
- Testing the clerical accuracy of inventory listings.
- Reconciling physical counts to perpetual records and general ledger balances and investigating significant fluctuations.

Rights and Obligations

The entity has legal title or similar rights of ownership to the inventories.

- Observing physical inventory counts.
- Obtaining confirmation of inventories at locations outside the entity.
- Examining paid vendors' invoices, consignment agreements, and contracts.

Inventories exclude items billed to customers or owned by others.

- Examining paid vendors' invoices, consignment agreements, and contracts.
- Testing shipping and receiving cutoff procedures.

Valuation or Allocation

Inventories are properly stated at cost (except when market is lower).

- Examining paid vendors' invoices.
- Reviewing direct labor rates.
- Testing the computation of standard overhead rates.
- Examining analyses of purchasing and manufacturing standard cost variances.

Slow-moving, excess, defective, and obsolete items included in inventories are properly identified.

- Examining an analysis of inventory turnover.
- Reviewing industry experience and trends.
- Analytically reviewing the relationship of inventory balances to

anticipated sales volume.

- Touring the plant.
- Inquiring of production and sales personnel concerning possible excess or obsolete inventory items.

Illustrative Audit Objectives

Inventories are reduced, when appropriate, to replacement cost or net realizable value.

Examples of Substantive Tests

- Obtaining current market value quotations.
- Reviewing current production costs.
- Examining sales after year-end and open purchase order commitments.

Presentation and Disclosure

Inventories are properly classified in the balance sheet as current assets.

- Reviewing drafts of the financial statements.

The major categories of inventories and their bases of valuation are adequately disclosed in the financial statements.

- Reviewing drafts of the financial statements.
- Comparing the disclosures made in the financial statements to the requirements of generally accepted accounting principles.

The pledge or assignment of any inventories is appropriately disclosed.

- Obtaining confirmation of inventories pledged under loan agreements.

[Formerly paragraph .23, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

AU Section 329***Analytical Procedures***

(Supersedes section 318 [See Appendix G])

Source: SAS No. 56.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits.

.02 Analytical procedures are an important part of the audit process and consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures range from simple comparisons to the use of complex models involving many relationships and elements of data. A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary. Particular conditions that can cause variations in these relationships include, for example, specific unusual transactions or events, accounting changes, business changes, random fluctuations, or misstatements.

.03 Understanding financial relationships is essential in planning and evaluating the results of analytical procedures, and generally requires knowledge of the client and the industry or industries in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures is also important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the auditor.

.04 Analytical procedures are used for the following purposes:

- a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures
- b. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions
- c. As an overall review of the financial information in the final review stage of the audit

Analytical procedures should be applied to some extent for the purposes referred to in (a) and (c) above for all audits of financial statements made in accordance with generally accepted auditing standards. In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

.05 Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the

auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

- a. Financial information for comparable prior period(s) giving consideration to known changes
- b. Anticipated results—for example, budgets, or forecasts including extrapolations from interim or annual data
- c. Relationships among elements of financial information within the period
- d. Information regarding the industry in which the client operates—for example, gross margin information
- e. Relationships of financial information with relevant nonfinancial information

Analytical Procedures in Planning the Audit

.06 The purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain evidential matter for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (a) enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date, and (b) identifying areas that may represent specific risks relevant to the audit. Thus, the objective of the procedures is to identify such things as the existence of unusual transactions and events, and amounts, ratios and trends that might indicate matters that have financial statement and audit planning ramifications.

.07 Analytical procedures used in planning the audit generally use data aggregated at a high level. Furthermore, the sophistication, extent and timing of the procedures, which are based on the auditor's judgment, may vary widely depending on the size and complexity of the client. For some entities, the procedures may consist of reviewing changes in account balances from the prior to the current year using the general ledger or the auditor's preliminary or unadjusted working trial balance. In contrast, for other entities, the procedures might involve an extensive analysis of quarterly financial statements. In both cases, the analytical procedures, combined with the auditor's knowledge of the business, serve as a basis for additional inquiries and effective planning.

.08 Although analytical procedures used in planning the audit often use only financial data, sometimes relevant nonfinancial information is considered as well. For example, number of employees, square footage of selling space, volume of goods produced, and similar information may contribute to accomplishing the purpose of the procedures.

Analytical Procedures Used as Substantive Tests

.09 The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion¹ may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor's judgment on the expected effectiveness and efficiency of the available procedures.

¹ Assertions are representations by management that are embodied in financial statement components. See section 326, *Evidential Matter*.

.10 The auditor considers the level of assurance, if any, he wants from substantive testing for a particular audit objective and decides, among other things, which procedure, or combination of procedures, can provide that level of assurance. For some assertions, analytical procedures are effective in providing the appropriate level of assurance. For other assertions, however, analytical procedures may not be as effective or efficient as tests of details in providing the desired level of assurance.

.11 The expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements depends on, among other things, (a) the nature of the assertion, (b) the plausibility and predictability of the relationship, (c) the availability and reliability of the data used to develop the expectation, and (d) the precision of the expectation.

Nature of Assertion

.12 Analytical procedures may be effective and efficient tests for assertions in which potential misstatements would not be apparent from an examination of the detailed evidence or in which detailed evidence is not readily available. For example, comparisons of aggregate salaries paid with the number of personnel may indicate unauthorized payments that may not be apparent from testing individual transactions. Differences from expected relationships may also indicate potential omissions when independent evidence that an individual transaction should have been recorded may not be readily available.

Plausibility and Predictability of the Relationship

.13 It is important for the auditor to understand the reasons that make relationships plausible because data sometimes appear to be related when they are not, which could lead the auditor to erroneous conclusions. In addition, the presence of an unexpected relationship can provide important evidence when appropriately scrutinized.

.14 As higher levels of assurance are desired from analytical procedures, more predictable relationships are required to develop the expectation. Relationships in a stable environment are usually more predictable than relationships in a dynamic or unstable environment. Relationships involving income statement accounts tend to be more predictable than relationships involving only balance sheet accounts since income statement accounts represent transactions over a period of time, whereas balance sheet accounts represent amounts as of a point in time. Relationships involving transactions subject to management discretion are sometimes less predictable. For example, management may elect to incur maintenance expense rather than replace plant and equipment, or they may delay advertising expenditures.

Availability and Reliability of Data

.15 Data may or may not be readily available to develop expectations for some assertions. For example, to test the completeness assertion, expected sales for some entities might be developed from production statistics or square feet of selling space. For other entities, data relevant to the assertion of completeness of sales may not be readily available, and it may be more effective or efficient to use the details of shipping records to test that assertion.

.16 The auditor obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources. The reliability of the data used to develop the expectations should be appropriate for the desired level of assurance from the

analytical procedure. The auditor should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data. The following factors influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives:

- Whether the data was obtained from independent sources outside the entity or from sources within the entity
- Whether sources within the entity were independent of those who are responsible for the amount being audited
- Whether the data was developed under a reliable system with adequate controls
- Whether the data was subjected to audit testing in the current or prior year
- Whether the expectations were developed using data from a variety of sources

Precision of the Expectation

.17 The expectation should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate (see paragraph .20). As expectations become more precise, the range of expected differences becomes narrower and, accordingly, the likelihood increases that significant differences from the expectations are due to misstatements. The precision of the expectation depends on, among other things, the auditor's identification and consideration of factors that significantly affect the amount being audited and the level of detail of data used to develop the expectation.

.18 Many factors can influence financial relationships. For example, sales are affected by prices, volume and product mix. Each of these, in turn, may be affected by a number of factors, and offsetting factors can obscure misstatements. More effective identification of factors that significantly affect the relationship is generally needed as the desired level of assurance from analytical procedures increases.

.19 Expectations developed at a detailed level generally have a greater chance of detecting misstatement of a given amount than do broad comparisons. Monthly amounts will generally be more effective than annual amounts and comparisons by location or line of business usually will be more effective than company-wide comparisons. The level of detail that is appropriate will be influenced by the nature of the client, its size and its complexity. Generally, the risk that material misstatement could be obscured by offsetting factors increases as a client's operations become more complex and more diversified. Disaggregation helps reduce this risk.

Investigation and Evaluation of Significant Differences

.20 In planning the analytical procedures as a substantive test, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account

balances, or class of transactions, or other balances or classes could aggregate to an unacceptable amount.²

.21 The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation and inquiry of management may assist the auditor in this regard. Management responses, however, should ordinarily be corroborated with other evidential matter. In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a likely misstatement.³ In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*.)

Analytical Procedures Used in the Overall Review

.22 The objective of analytical procedures used in the overall review stage of the audit is to assist the auditor in assessing the conclusions reached and in the evaluation of the overall financial statement presentation. A wide variety of analytical procedures may be useful for this purpose. The overall review would generally include reading the financial statements and notes and considering (a) the adequacy of evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit and (b) unusual or unexpected balances or relationships that were not previously identified. Results of an overall review may indicate that additional evidence may be needed.

Effective Date

.23 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

[The next page is 331.]

² See section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraphs .17 through .19.

³ See section 312.28.

AU Section 331

Receivables and Inventories

Sources: SAS No. 1, section 331; SAS No. 43.

See section 9331 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 Confirmation of receivables and observation of inventories are generally accepted auditing procedures. The independent auditor who issues an opinion when he has not employed them must bear in mind that he has the burden of justifying the opinion expressed.

.02 The purpose of this section is to provide guidelines for the independent auditor in confirming receivables and observing inventories. This section relates only to confirmation of receivables and observation of inventories and does not deal with other important auditing procedures which generally are required for the independent auditor to satisfy himself as to these assets.

Receivables

.03 Confirmation of receivables requires direct communication with debtors either during or after the period under audit; the confirmation date, the method of requesting confirmations, and the number to be requested are determined by the independent auditor. Such matters as the effectiveness of internal control, the apparent possibility of disputes, inaccuracies or irregularities in the accounts, the probability that requests will receive consideration or that the debtor will be able to confirm the information requested, and the materiality of the amounts involved are factors to be considered by the auditor in selecting the information to be requested and the form of confirmation, as well as the extent and timing of his confirmation procedures.

.04 Two forms of confirmation request are (a) the "positive" form of request, wherein the debtor is asked to respond whether or not he is in agreement with the information given, and (b) the "negative" form of request, wherein the debtor is asked to respond only if he disagrees with the information given.

.05 Because the use of the positive form results in either (a) the receipt of a response from the debtor constituting evidence regarding the debt or (b) the use of other procedures to provide evidence as to the validity and accuracy of significant ¹ non-responding accounts, the use of the positive form is preferable when individual account balances are relatively large or when there is reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. The negative form is useful particularly

¹ In this context, "significant" refers to those confirmation requests that the auditor believes would be likely to influence his evaluation of the accounts selected for confirmation. In making his decision in this respect, the auditor should be mindful that such evaluation is to be extended to the accounts receivable as a whole and therefore he should consider the basis on which he determined the number and amount of confirmations requested, the method of selection of the particular accounts, and any unusual factors relevant in the circumstances.

when internal control surrounding accounts receivable is considered to be effective, when a large number of small balances are involved, and when the auditor has no reason to believe the persons receiving the requests are unlikely to give them consideration. If the negative rather than the positive form of confirmation is used, the number of requests sent or the extent of the other auditing procedures applied to the receivable balance should normally be greater in order for the independent auditor to obtain the same degree of satisfaction with respect to the accounts receivable balance.

.06 In many situations a combination of the two forms may be appropriate, with the positive form used for large balances and the negative form for small balances.

.07 Confirmation procedures may be directed toward account balances with debtors or toward individual items included in such balances. The latter procedure may be particularly useful when the nature of the accounts or the debtors' records are not likely to permit successful confirmation of account balances.

.08 When the independent auditor sets out to confirm receivables by means of positive requests, he should generally follow up with a second and sometimes an additional request to those debtors from whom he receives no reply. The auditor should employ such alternative procedures as are practicable to obtain adequate evidence necessary to satisfy himself as to those significant² requests for which he receives no replies. These procedures may include examination of evidence of subsequent cash receipts, cash remittance advices, sales and shipping documents, and other records.

Inventories

.09 When inventory quantities are determined solely by means of a physical count, and all counts are made as of the balance-sheet date or as of a single date within a reasonable time before or after the balance-sheet date, it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests, and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client's representations about the quantities and physical condition of the inventories.

.10 When the well-kept perpetual inventory records are checked by the client periodically by comparisons with physical counts, the auditor's observation procedures usually can be performed either during or after the end of the period under audit.

² See definition of "significant" in footnote 1 to paragraph .05.

.11 In recent years, some companies have developed inventory controls or methods of determining inventories, including statistical sampling, which are highly effective in determining inventory quantities and which are sufficiently reliable to make unnecessary an annual physical count of each item of inventory. In such circumstances, the independent auditor must satisfy himself that the client's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year. The auditor must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used. If statistical sampling methods are used by the client in the taking of the physical inventory, the auditor must be satisfied that the sampling plan is reasonable and statistically valid, that it has been properly applied, and that the results are reasonable in the circumstances. [As modified by the issuance of SAS No. 39.] (See section 350.)

.12 When the independent auditor has not satisfied himself as to inventories in the possession of the client through the procedures described in paragraphs .09—.11, tests of the accounting records alone will not be sufficient for him to become satisfied as to quantities; it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions. This should be coupled with a review of the records of any client's counts and procedures relating to the physical inventory on which the balance-sheet inventory is based.

.13 The independent auditor may be asked to make an examination of financial statements covering the current period and one or more periods for which he had not observed or made some physical counts of prior inventories. He may, nevertheless, be able to become satisfied as to such prior inventories through appropriate procedures, such as tests of prior transactions, reviews of the records of prior counts, and the application of gross profit tests, provided that he has been able to become satisfied as to the current inventory.

Inventories Held in Public Warehouses ³

.14 If inventories are in the hands of public warehouses or other outside custodians, the auditor ordinarily would obtain direct confirmation in writing from the custodian. If such inventories represent a significant proportion of current or total assets, to obtain reasonable assurance with respect to their existence, the auditor should apply one or more of the following procedures as he considers necessary in the circumstances.

- a. Review and test the owner's control procedures for investigating the warehouseman and evaluating the warehouseman's performance.
- b. Obtain an independent accountant's report on the warehouseman's system of internal accounting control relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable.
- c. Observe physical counts of the goods, if practicable and reasonable.
- d. If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate).

[As amended, (by replacing paragraphs .14 and .15 with a new paragraph .14), effective after August 31, 1982 by Statement on Auditing Standards No. 43.]

³ See section 901 for Special Report of Committee on Auditing Procedure.

Effect on the Auditor's Report

.15 For a discussion of the circumstances relating to receivables and inventories affecting the independent auditor's report, see sections 509.12 (in Appendix G) and 542.05 (in Appendix G). [As amended, effective for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2.] (See section 509 in Appendix G.) [Formerly paragraph .16, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

[The next page is 341.]

AU Section 332

Long-Term Investments

Sources: SAS No. 1, section 332; SAS No. 2.

See section 9332 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 The purpose of this section is to furnish guidance in applying generally accepted auditing standards to examinations of the financial statements of companies with long-term investments accounted for under either the cost method or the equity method. Such investments may be represented by capital stock or other equity interests, bonds and similar debt obligations, and loans and advances that are in the nature of investments. This section is concerned with evidential matter which should be examined by the auditor in corroboration of (a) amounts at which long-term investments are stated in financial statements of the investor, (b) amounts reported as the investor's share of earnings or losses and other transactions of the investee, and (c) related disclosures.

Objectives of Examination

.02 The independent auditor should ascertain whether long-term investments are accounted for in conformity with generally accepted accounting principles consistently applied and whether the related disclosures are adequate. He should, therefore, examine sufficient competent evidential matter supporting the existence, ownership, cost, and carrying amount of investments, income and losses attributable to such investments, and any related disclosures in the investor's financial statements. With respect to investments accounted for under the equity method, he should also examine such evidential matter regarding the investor's accounting for its share of capital and other transactions of the investee.

.03 With respect to the carrying amount of investments, a loss in value which is other than a temporary decline should be recognized in the financial statements of an investor.* The independent auditor should, therefore, also examine sufficient competent evidential matter to the extent he deems necessary to determine whether such a loss in value has occurred.

Types of Evidence

.04 Evidential matter pertaining to the existence, ownership, and cost of long-term investments includes accounting records and documents of the investor relating to their acquisition. In the case of investments in the form of securities (such as stocks, bonds, and notes), this evidential matter should be corroborated by inspection of the securities, or in appropriate circumstances, by written confirmation from an independent custodian of securities on deposit, pledged, or in safekeeping. In the case of loans, advances, and registered bonds and similar debt obligations, evidential matter obtained from

* See FASB Statement No. 12 [AC section I89], *Accounting for Certain Marketable Securities*.

accounting records and documents also should be corroborated by written confirmation from the debtor or trustee.

.05 Evidential matter pertaining to the carrying amount of long-term investments, income and losses attributable to such investments, and capital and other transactions of the investee may be available in the following forms:

a. Audited Financial Statements

Financial statements of the investee generally constitute sufficient evidential matter as to the equity in underlying net assets and results of operations of the investee when such statements have been examined by the investor's auditor or by another independent auditor whose report is satisfactory, for this purpose, to the investor's auditor. Audited financial statements also constitute one of the items of evidential matter that may be used with respect to investments in bonds and similar debt obligations, loans, and advances.

b. Unaudited Financial Statements

- (i) Unaudited financial statements, reports issued on examination by regulatory bodies and taxing authorities, and similar data provide information and evidence but are not by themselves sufficient as evidential matter.
- (ii) By application of auditing procedures to the financial statements of an investee, the auditor obtains evidential matter as to the equity in underlying net assets and results of operations of the investee. The auditor for the investor may utilize the investee's auditor for this purpose. The materiality of the investment in relation to the financial statements of the investor is a factor which should be considered in determining the extent and nature of such procedures.

c. Market Quotations

If market quotations of security prices are based on a reasonably broad and active market, they ordinarily constitute sufficient competent evidential matter as to the current market value of unrestricted securities.

d. Other Evidential Matter

- (i) When the carrying amount of an investment reflects (a) factors (such as mineral rights, growing timber, patents, and goodwill) which are not recognized in financial statements of the investee or (b) fair values of assets which are materially different from the investee's carrying amounts, evidential matter may be available in the form of current evaluations of these factors. Evaluations made by persons within the investor or within the investee may be acceptable; evaluations made by persons independent of these

companies will usually provide greater assurance of reliability than evaluations made by persons within the companies.

- (ii) Negotiable securities, real estate, chattels, or other property are often assigned as collateral for investments in bonds, notes, loans, or advances. If the collateral is an important factor in considering collectibility of the obligation, the auditor should satisfy himself regarding the existence and transferability of such collateral and should obtain evidential matter as to its value (such as market quotations, the amount of underlying net assets, or appraisals) as may be appropriate in the circumstances.

Equity Method of Accounting

.06 Paragraph 17 of Accounting Principles Board Opinion No. 18 [AC section I82.104] states that the equity method of accounting for an investment in common stock should be used by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. It also provides several criteria to be considered in determining whether the investor has the ability to exercise significant influence. Paragraph 16 of Opinion No. 18 [AC section I82.103] states that the equity method should also be followed for investments in common stock of corporate joint ventures.

.07 The auditor has a responsibility to satisfy himself with respect to the appropriateness of the accounting method adopted for investments in voting stock of an investee. Inquiry should be made of the investor's management as to (a) whether the investor has the ability to exercise significant influence over operating and financial policies of the investee under the criteria set forth in paragraph 17 of Opinion No. 18 [AC section I82.104] and (b) the attendant circumstances which serve as a basis for management's conclusion. The auditor should evaluate the information received on the basis of facts otherwise obtained by him in the course of his audit.

.08 When an investor accounts for an investment in an investee contrary to the applicable presumption contained in paragraph 17 of Opinion No. 18¹ [AC section I82.104], the auditor should examine sufficient competent evidential matter to satisfy himself that such presumption has been overcome and that appropriate disclosure is made regarding the reasons for not accounting for the investment in keeping with the presumption.²

¹ Paragraph 17 [AC section I82.104] states: "... an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such an ability can be demonstrated."

² See Accounting Principles Board Opinion No. 18, paragraph 20, footnote 13 [AC section I82.110, footnote 14].

.09 The refusal of an investee to furnish necessary financial data to the investor is evidence (but not necessarily conclusive evidence) that the investor does not have the ability to exercise significant influence over operating and financial policies of the investee such as to justify the application of the equity method of accounting for investments in 50% or less owned companies in accordance with the provisions of Opinion No. 18 [AC section I82].*

.10 An investor should include its proportionate share of an investee's results of operations based on data obtained from the investee's most recent reliable financial statements, which may be its audited year-end statements.

.11 An investor may include its proportionate share of the results of operations of an investee based on the investee's unaudited interim financial statements. An example of this would be a situation in which an investor whose year ends on June 30 includes its equity in earnings of an investee based on the investee's financial statements for the six-month period ended December 31 and the six-month period ended June 30. In such situations, the auditor for the investor should recognize that although the investee's financial statements for the year ended December 31 may have been audited, the financial statements as of June 30 and for the year then ended represent unaudited data because neither six-month period is covered by an auditor's report. Auditing procedures (see paragraph .05 b(ii)) should be applied to such unaudited financial statements to the extent considered necessary in view of their materiality in relation to the financial statements of the investor.

.12 In many instances there will be a time lag in reporting between the dates of the financial statements of the investor and those of the investee. A time lag in reporting should be consistent from period to period. If a change in time lag occurs which the auditor deems to have a material effect on the investor's financial statements, he should express in his opinion an exception as to consistency.

.13 With respect to events and transactions of the investee from the date of the investee's financial statements to the date of the report of the auditor of the investor, the auditor should read available interim financial statements of the investee and make appropriate inquiries of the investor. Further, the auditor should ascertain through such inquiries that the investor has made itself aware of any material events or transactions arising subsequent to the date of the investee's financial statements. Such events or transactions of the type contemplated by section 560.05-.06, which are material in relation to the financial statements of the investor, should be disclosed in the notes to the investor's financial statements and (where applicable) labeled as unaudited information. For the purpose of recording the investor's share of the results of operations of the investee, recognition should be given to events or transactions of the type contemplated by section 560.03 which are material in relation to the financial statements of the investor.

.14 In certain circumstances, events or transactions during the period between the date of the investee's financial statements and the date of the

* See also FASB Interpretation No. 35, paragraph 4(d) [AC section I82.108(d)].

investor's financial statements may be of such a nature and significance as to cause a loss in value of the investment which should be recognized in the investor's financial statements (see paragraph 19h of Opinion No. 18) [AC section I82.109h].

.15 For investments accounted for under the equity method, data relating to transactions between the investor and investee should be obtained for purposes of determining the proper elimination of unrealized intercompany profits and losses. Normally, such data are not shown separately in the financial statements of the investee and may have to be obtained from the investee. If the amounts of unrealized intercompany profits or losses could reasonably be expected to be material in relation to the investor's financial position or results of operations, unaudited data obtained from the investee ordinarily should be subjected to auditing procedures (see paragraph .05 b(ii)).

Effect on the Auditor's Report

.16 For a discussion of circumstances relating to long-term investments affecting the independent auditor's report, see sections 542.06 (in Appendix G) and 543.14. [As amended, effective for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2.] (See section 509 in Appendix G.)

[The next page is 347.]

AU Section 333

Client Representations

Source: SAS No. 19.

See section 9333 for interpretations of this section.

Effective for periods ending on or after September 30, 1977, unless otherwise indicated.

.01 This section establishes a requirement that the independent auditor obtain written representations from management as a part of an examination made in accordance with generally accepted auditing standards and provides guidance concerning the representations to be obtained.

Reliance on Management Representations

.02 During an examination, management makes many representations to the auditor, both oral and written, in response to specific inquiries or through the financial statements. Such representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for his opinion on the financial statements. Written representations from management ordinarily confirm oral representations given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations.

.03 The auditor obtains written representations from management to complement his other auditing procedures. In many cases, the auditor applies auditing procedures specifically designed to obtain corroborating information concerning matters that are also the subject of written representations. For example, after the auditor performs the procedures prescribed in section 334, *Related Parties*, even if the results of those procedures indicate that transactions with related parties have been properly disclosed, he should obtain a written representation to document that management has no knowledge of any such transactions that have not been disclosed. In some cases involving written representations, the corroborating information that can be obtained by the application of auditing procedures other than inquiry is limited. When a client plans to discontinue a line of business, for example, the auditor may not be able to obtain information through other auditing procedures to corroborate the plan or intent. Accordingly, the auditor should obtain a written representation to provide confirmation of management's intent. Unless the auditor's examination reveals evidential matter to the contrary, his reliance on the truthfulness of management's representations is reasonable.¹ [Reference changed August, 1983, by the issuance of Statement on Auditing Standards No. 45.] (See section 334.)

¹ See section 327.09—10 in Appendix G.

Obtaining Written Representations²

.04 The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. They ordinarily include the following matters, if applicable:

- a. Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles or other comprehensive basis of accounting.
- b. Availability of all financial records and related data.
- c. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.
- d. Absence of errors in the financial statements and unrecorded transactions.
- e. Information concerning related party transactions and related amounts receivable or payable.³
- f. Noncompliance with aspects of contractual agreements that may affect the financial statements.
- g. Information concerning subsequent events.⁴
- h. Irregularities involving management or employees.⁵
- i. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
- j. Plans or intentions that may affect the carrying value or classification of assets or liabilities.
- k. Disclosure of compensating balance or other arrangements involving restrictions on cash balances, and disclosure of line-of-credit or similar arrangements.
- l. Reduction of excess or obsolete inventories to net realizable value.
- m. Losses from sales commitments.
- n. Satisfactory title to assets, liens on assets, and assets pledged as collateral.
- o. Agreements to repurchase assets previously sold.
- p. Losses from purchase commitments for inventory quantities in excess of requirements or at prices in excess of market.
- q. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.⁶
- r. Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5 [AC section C59].⁷

² An illustrative representation letter from management is contained in the Appendix (section 333A).

³ See section 334. [Reference changed August, 1983, by the issuance of Statement on Auditing Standards No. 45.]

⁴ See sections 560.12 and 711.10. [Reference changed by issuance of Statement on Auditing Standards No. 37.]

⁵ See section 327 in Appendix G.

⁶ See section 328 in Appendix G.

⁷ See section 337.05.

- s. Unasserted claims or assessments that the client's lawyer has advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59].⁸
- t. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.

.05 Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on the limits of materiality for this purpose. Such limitations would not apply to those representations that are not directly related to amounts included in the financial statements, for example, items (a), (b), and (c) above. In addition, because of the possible effects of irregularities on other aspects of the auditor's examination, a materiality limit would not apply to item (h) above with respect to management and those personnel who have significant roles in the system of internal accounting control.

.06 In addition to matters such as those indicated above, the auditor may determine, based on the circumstances of the engagement, that other matters should be specifically included in written representations from management.⁹ For example, if a company excludes a short-term obligation from current liabilities because it intends to refinance the obligation on a long-term basis, the auditor should obtain a specific representation of management's intent to consummate the refinancing.¹⁰ Also, the auditor should obtain written representations concerning interim financial information accompanying audited financial statements. [As modified, May 1981, by the Auditing Standards Board.]

.07 In certain instances, the auditor may request other written representations from management in addition to evidential matter obtained through other procedures. For example, although the auditor may be satisfied with the method of pricing inventories, he may ask management to furnish a representation concerning inventory pricing.

.08 If the independent auditor is reporting on consolidated financial statements, the written representations obtained from the parent company's management should specify that they pertain to the consolidated financial statements and, if applicable, to the separate financial statements of the parent company.

.09 The written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of his report that may require adjustment to or disclosure in the financial statements, the representations should be dated as of the date of the auditor's report. They should be signed by members of management whom the auditor believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations. Normally, the chief executive officer and chief financial officer should sign the representations.

.10 In certain circumstances, the auditor may want to obtain written representations from other individuals. For example, he may want to obtain

⁸ See section 337.05.

⁹ Certain AICPA audit guides require or recommend that the auditor obtain written representations concerning matters that are unique to a particular industry. This section does not supersede those requirements or recommendations.

¹⁰ See Statement of Financial Accounting Standards No. 6, paragraphs 9 through 11 [AC section B05.113].

written representations about the completeness of the minutes of the meetings of stockholders, directors, and committees of directors from the person responsible for keeping such minutes. Also, if the independent auditor examines the financial statements of a subsidiary but does not examine those of the parent company, he may want to obtain representations from management of the parent company concerning matters that may affect the subsidiary, such as related party transactions or the parent company's intention to provide continuing financial support to the subsidiary.

Scope Limitations ¹¹

.11 Management's refusal to furnish written representations constitutes a limitation on the scope of the auditor's examination sufficient to preclude an unqualified opinion. Further, the auditor should consider the effects of management's refusal on his ability to rely on other of their representations.

.12 If the auditor is precluded from performing procedures he considers necessary in the circumstances with respect to a matter that is material to the financial statements, even though he has been given representations from management concerning the matter, there is a limitation on the scope of his examination, and he should qualify his opinion or disclaim an opinion.

Effective Date

.13 Statements on Auditing Standards generally are effective at the time of their issuance. However, since this section provides for practices that may differ in certain respects from practices heretofore considered acceptable, this section will be effective for examinations made in accordance with generally accepted auditing standards for periods ending on or after September 30, 1977.

¹¹ See section 509.10—.12 in Appendix G.

AU Section 333A**Appendix—Illustrative
Representation
Letter**

Source: SAS No. 19.

.01 The following letter is presented for illustrative purposes only. The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being examined. The introductory paragraph should specify the financial statements and periods covered by the auditor's report, for example, "balance sheets of XYZ Company as of December 31, 19X1 and 19X0, and the related statements of income and retained earnings and changes in financial position for the years then ended." Similarly, representations concerning inventories and sales and purchase commitments would not be obtained if such items are not material to the company's financial position and results of operations or if they are not recorded in the financial statements under a comprehensive basis of accounting other than generally accepted accounting principles, for example, financial statements prepared on the cash basis of accounting.

.02 The illustrative letter assumes that there are no matters requiring specific disclosure to the auditor. If such matters exist, they should be indicated by listing them following the representation, by reference to accounting records or financial statements, or by other similar means. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, item 14 could be modified as follows: "Except as discussed in Note X to the financial statements, no events have occurred. . . ." Similarly, in appropriate circumstances, item 4 could be modified as follows: "We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except that certain marketable securities have been excluded from current assets based on our intention not to dispose of them, which is supported by the minutes of the December 7, 19X1, meeting of the board of directors."

.03 Certain terms are used in the illustrative letter that are defined elsewhere in authoritative literature, for example, irregularities (section 327 in Appendix G) and related parties (section 334.01, footnote 1). To avoid misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to the client and request that the client include the definitions in the written representations. [Reference changed August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 334.)

.04 The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in section 333.05.

.05

(Date of Auditor's Report)

(To Independent Auditor)

In connection with your examination of the (identification of financial statements) of (name of client) as of (date) and for the (period of examination) for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly the financial position, results of operations, and changes in financial position of (name of client) in conformity with generally accepted accounting principles (other comprehensive basis of accounting), we confirm, to the best of our knowledge and belief, the following representations made to you during your examination.

1. We are responsible for the fair presentation in the (consolidated) financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles (other comprehensive basis of accounting).
2. We have made available to you all—
 - a. Financial records and related data.
 - b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no—
 - a. Irregularities involving management or employees who have significant roles in the system of internal accounting control.
 - b. Irregularities involving other employees that could have a material effect on the financial statements.
 - c. Communications from regulatory agencies concerning non-compliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.
4. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
5. The following have been properly recorded or disclosed in the financial statements:
 - a. Related party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.
 - b. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.
 - c. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements.
 - d. Agreements to repurchase assets previously sold.
6. There are no—
 - a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

- b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5 [AC section C59].
- 7. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59].
- 8. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
- 9. Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.
- 10. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.
- 11. Provision has been made for any material loss to be sustained in the fulfillment of, or from inability to fulfill, any sales commitments.
- 12. Provision has been made for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.
- 13. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
- 14. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

(Name of Chief Executive
Officer and Title)

(Name of Chief Financial
Officer and Title)

[The next page is 355.]

AU Section 334

Related Parties

(Supersedes Statement on Auditing Standards

No. 6, AICPA, Professional Standards,

*vol. 1, AU sec. 335.01—.19)**

Source: SAS No. 45.

See section 9334 for interpretations of this section.

Effective for periods ended after September 30, 1983, unless otherwise indicated.

.01 This section provides guidance on procedures that should be considered by the auditor when he is performing an examination of financial statements in accordance with generally accepted auditing standards to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure.¹ The procedures set forth in this section should not be considered all-inclusive. Also, not all of them may be required in every examination.

Accounting Considerations

.02 FASB Statement No. 57 [AC section R36], *Related Party Disclosures*, gives the requirements for related party disclosures. Certain accounting pronouncements prescribe the accounting treatment when related parties are involved; however, established accounting principles ordinarily do not require transactions with related parties to be accounted for on a basis different from that which would be appropriate if the parties were not related. The auditor should view related party transactions within the framework of existing

* This section also withdraws the following auditing interpretations dated March 1976 (AICPA, *Professional Standards*, vol. 1, AU sec. 9335.01—.11):

- Evaluating the Adequacy of Disclosure of Related Party Transactions
- Disclosure of Commonly Controlled Parties
- Definition of "Immediate Family"

¹ Financial Accounting Standards Board Statement No. 57, *Related Party Disclosures*, paragraphs 2 through 4 [AC section R36.102—.104], contains the disclosure requirements for related party relationships and transactions. The glossary of that Statement [AC section R36.406] defines related parties as follows:

Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

The glossary also gives definitions of the terms "affiliate," "control," "immediate family," "management," and "principal owners" [AC section R36.401—.405]. Paragraph 1 of the FASB Statement [AC section R36.101] gives examples of related party transactions.

pronouncements, placing primary emphasis on the adequacy of disclosure. In addition, the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form.²

.03 Transactions that because of their nature may be indicative of the existence of related parties include³—

- a. Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.
- b. Selling real estate at a price that differs significantly from its appraised value.
- c. Exchanging property for similar property in a nonmonetary transaction.
- d. Making loans with no scheduled terms for when or how the funds will be repaid.

Audit Procedures

.04 An examination made in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered. Nevertheless, during the course of his examination, the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships for which FASB Statement No. 57 [AC section R36] requires disclosure even though there are no transactions. Many of the procedures outlined in the following paragraphs are normally performed in an examination in accordance with generally accepted auditing standards, even if the auditor has no reason to suspect that related party transactions or control relationships exist. Other audit procedures set forth in this section are specifically directed to related party transactions.

² Accounting Principles Board Statement No. 4, paragraph 35, states, "Although financial accounting is concerned with both the legal and economic effects of transactions and other events and many of its conventions are based on legal rules, the economic substance of transactions and other events are usually emphasized when economic substance differs from legal form." Other pronouncements specify criteria for determining, presenting, and accounting for the substance of certain transactions and events. Examples include (1) presenting consolidated financial statements instead of separate statements of the component legal entities (Accounting Research Bulletin No. 51 [AC section C51]); (2) capitalizing leases (FASB Statement No. 13 [AC section L10]); and (3) imputing an appropriate interest rate when the face amount of a note does not reasonably represent the present value of the consideration given or received in exchange for it (Accounting Principles Board Opinion No. 21 [AC section I69]).

³ FASB Statement No. 57, paragraph 1 [AC section R36.101], gives other examples of common types of transactions with related parties, and it states that "transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition."

.05 In determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component to the total entity. He should consider internal accounting controls over management activities, and he should consider the business purpose served by the various components of the entity. Normally, the business structure and style of operating are based on the abilities of management, tax and legal considerations, product diversification, and geographical location. Experience has shown, however, that business structure and operating style are occasionally deliberately designed to obscure related party transactions.

.06 In the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business. The auditor should, however, be aware of the possibility that transactions with related parties may have been motivated solely, or in large measure, by conditions similar to the following:

- a. Lack of sufficient working capital or credit to continue the business
- b. An urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's stock
- c. An overly optimistic earnings forecast
- d. Dependence on a single or relatively few products, customers, or transactions for the continuing success of the venture
- e. A declining industry characterized by a large number of business failures
- f. Excess capacity
- g. Significant litigation, especially litigation between stockholders and management
- h. Significant obsolescence dangers because the company is in a high-technology industry

Determining the Existence of Related Parties

.07 The auditor should place emphasis on auditing material transactions with parties he knows are related to the reporting entity. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of specific audit procedures, which may include the following:

- a. Evaluate the company's procedures for identifying and properly accounting for related party transactions.
- b. Request from appropriate management personnel the names of all related parties and inquire whether there were any transactions with these parties during the period.
- c. Review filings by the reporting entity with the Securities and Exchange Commission and other regulatory agencies for the names of related parties and for other businesses in which officers and directors occupy directorship or management positions.

- d. Determine the names of all pension and other trusts established for the benefit of employees and the names of their officers and trustees.⁴
- e. Review stockholder listings of closely held companies to identify principal stockholders.
- f. Review prior years' working papers for the names of known related parties.
- g. Inquire of predecessor, principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions.
- h. Review material investment transactions during the period under examination to determine whether the nature and extent of investments during the period create related parties.

Identifying Transactions With Related Parties

.08 The following procedures are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships:

- a. Provide audit personnel performing segments of the examination or examining and reporting separately on the accounts of related components of the reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their examinations.
- b. Review the minutes of meetings of the board of directors and executive or operating committees for information about material transactions authorized or discussed at their meetings.
- c. Review proxy and other material filed with the Securities and Exchange Commission and comparable data filed with other regulatory agencies for information about material transactions with related parties.
- d. Review conflict-of-interests statements obtained by the company from its management.⁵
- e. Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships.
- f. Consider whether transactions are occurring, but are not being given accounting recognition, such as receiving or providing accounting, management or other services at no charge or a major stockholder absorbing corporate expenses.

⁴ According to FASB Statement No. 57, paragraph 24(f) [AC section R36.406] "trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management," are related parties.

⁵ Conflict-of-interests statements are intended to provide the board of directors with information about the existence or nonexistence of relationships between the reporting persons and parties with whom the company transacts business.

- g.* Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.
- h.* Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.
- i.* Review invoices from law firms that have performed regular or special services for the company for indications of the existence of related parties or related party transactions.
- j.* Review confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.

Examining Identified Related Party Transactions

.09 After identifying related party transactions, the auditor should apply the procedures he considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management. Procedures that should be considered include the following:

- a.* Obtain an understanding of the business purpose of the transaction.⁶
- b.* Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents.
- c.* Determine whether the transaction has been approved by the board of directors or other appropriate officials.
- d.* Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements.
- e.* Arrange for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.
- f.* Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

.10 When necessary to fully understand a particular transaction, the following procedures, which might not otherwise be deemed necessary to comply with generally accepted auditing standards, should be considered.⁷

- a.* Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.
- b.* Inspect evidence in possession of the other party or parties to the transaction.

⁶ Until the auditor understands the business sense of material transactions, he cannot complete his examination. If he lacks sufficient specialized knowledge to understand a particular transaction, he should consult with persons who do have the requisite knowledge.

⁷ Arrangements for certain procedures should be made or approved in advance by appropriate client officials.

- c. Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.
- d. Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.
- e. With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

Disclosure

.11 For each material related party transaction (or aggregation of similar transactions) or common ownership or management control relationship for which FASB Statement No. 57 [AC section R36] requires disclosure, the auditor should consider whether he has obtained sufficient competent evidential matter to understand the relationship of the parties and, for related party transactions, the effects of the transaction on the financial statements. He should then evaluate all the information available to him concerning the related party transaction or control relationship and satisfy himself on the basis of his professional judgment that it is adequately disclosed in the financial statements.⁸

.12 Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions.⁹ If such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, he should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality (see section 509.15 and .16 in Appendix G).

[The next page is 371.]

⁸ The disclosure standards are contained in FASB Statement No. 57, paragraphs 2 through 4 [AC section R36.102—.104]. Also, see section 431, *Adequacy of Disclosure in Financial Statements*.

⁹ FASB Statement No. 57, paragraph 3 [AC section R36.103], states that if representations are made about transactions with related parties, the representations "shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated."

AU Section 336

Using the Work of a Specialist

Source: SAS No. 11.

See section 9336 for interpretations of this section.

Issue date, unless otherwise indicated: December, 1975.

.01 The purpose of this section is to provide guidance to the auditor who uses the work of a specialist in performing an examination of financial statements in accordance with generally accepted auditing standards.¹ For purposes of this section, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. Examples of such specialists include actuaries, appraisers, attorneys, engineers, and geologists.²

Decision to Use the Work of a Specialist

.02 The auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. During his examination, however, an auditor may encounter matters potentially material to the fair presentation of financial statements in conformity with generally accepted accounting principles that require special knowledge and that in his judgment require using the work of a specialist.

.03 Examples of the types of matters that the auditor may decide require him to consider using the work of a specialist include, but are not limited to, the following:

- a. Valuation (e.g., works of art, special drugs, and restricted securities).
- b. Determination of physical characteristics relating to quantity on hand or condition (e.g., mineral reserves or materials stored in piles above ground).
- c. Determination of amounts derived by using specialized techniques or methods (e.g., certain actuarial determinations).
- d. Interpretation of technical requirements, regulations, or agreements (e.g., the potential significance of contracts or other legal documents, or legal title to property).

.04 In performing an examination of financial statements in accordance with generally accepted auditing standards, the auditor may use the work of a

¹ This section does not apply to using the work of a specialist who is a member of the auditor's staff, or to the form or content of letters of audit inquiry concerning litigation, claims, or assessments and lawyers' responses thereto.

² For purposes of this section, a person whose special skill or knowledge relates to the internal affairs or business practices of the client, such as a credit or plant manager, is not considered a specialist.

specialist as an audit procedure to obtain competent evidential matter. The circumstances surrounding the use of a specialist differ. Although the familiarity of individual auditors with the work performed by certain types of specialists may differ, the auditing procedures necessary to comply with generally accepted auditing standards need not vary as a result of the extent of the auditor's knowledge.

Selecting a Specialist

.05 The auditor should satisfy himself concerning the professional qualifications and reputation of the specialist by inquiry or other procedures, as appropriate. The auditor should consider the following:

- a. The professional certification, license, or other recognition of the competence of the specialist in his field, as appropriate.
- b. The reputation and standing of the specialist in the views of his peers and others familiar with his capability or performance.
- c. The relationship, if any, of the specialist to the client.

.06 Ordinarily, the auditor should attempt to obtain a specialist who is unrelated to the client. However, when the circumstances so warrant, work of a specialist having a relationship to the client may be acceptable (see paragraph .08). Work of a specialist unrelated to the client will usually provide the auditor with greater assurance of reliability because of the absence of a relationship that might impair objectivity.

.07 An understanding should exist among the auditor, the client, and the specialist as to the nature of the work to be performed by the specialist. Preferably, the understanding should be documented and should cover the following:

- a. The objectives and scope of the specialist's work.
- b. The specialist's representations as to his relationship, if any, to the client.
- c. The methods or assumptions to be used.
- d. A comparison of the methods or assumptions to be used with those used in the preceding period.
- e. The specialist's understanding of the auditor's corroborative use of the specialist's findings in relation to the representations in the financial statements.
- f. The form and content of the specialist's report that would enable the auditor to make the evaluation described in paragraph .08.

Using the Findings of the Specialist

.08 Although the appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist, the auditor should obtain an understanding of the methods or assumptions

used by the specialist to determine whether the findings are suitable for corroborating the representations in the financial statements. The auditor should consider whether the specialist's findings support the related representations in the financial statements and make appropriate tests of accounting data provided by the client to the specialist. Ordinarily, the auditor would use the work of the specialist unless his procedures lead him to believe that the findings are unreasonable in the circumstances. If the specialist is related to the client (see paragraph .06), the auditor should consider performing additional procedures with respect to some or all of the related specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or engage an outside specialist for that purpose.

Effect of the Specialist's Work on the Auditor's Report

.09 If the auditor determines that the specialist's findings support the related representations in the financial statements, he may reasonably conclude that he has obtained sufficient competent evidential matter. If there is a material difference between the specialist's findings and the representations in the financial statements, or if the auditor believes that the determinations made by the specialist are unreasonable, he should apply additional procedures. If after applying any additional procedures that might be appropriate he is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved will ordinarily cause the auditor to conclude that he should qualify his opinion or disclaim an opinion because the inability to obtain sufficient competent evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation (see section 509.10—.11 in Appendix G).

.10 The auditor may conclude after performing additional procedures, including possibly obtaining the opinion of another specialist, that the representations in the financial statements are not in conformity with generally accepted accounting principles. In that event, he should express a qualified or adverse opinion (see section 509.15—.17 in Appendix G).

Reference to the Specialist in the Auditor's Report

.11 When expressing an unqualified opinion, the auditor should not refer to the work or findings of the specialist. Such a reference in an unqualified opinion might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.

.12 If the auditor decides to modify his opinion (see paragraphs .09 and .10) as a result of the report or findings of the specialist, reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the modification.

[The next page is 381.]

AU Section 337***Inquiry of a Client's Lawyer Concerning
Litigation, Claims,
and Assessments¹***

Source: SAS No. 12.

See section 9337 for interpretations of this section.

Issue date, unless otherwise indicated: January, 1976.

.01 This section provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for satisfying himself as to the financial accounting and reporting for such matters when he is performing an examination in accordance with generally accepted auditing standards.

Accounting Considerations

.02 Management is responsible for adopting policies and procedures to identify, evaluate, and account for litigation, claims, and assessments as a basis for the preparation of financial statements in conformity with generally accepted accounting principles.

.03 The standards of financial accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments, are set forth in Statement of Financial Accounting Standards No. 5 [AC section C59], *Accounting for Contingencies*.²

Auditing Considerations

.04 With respect to litigation, claims, and assessments, the independent auditor should obtain evidential matter relevant to the following factors:

- a. The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments.
- b. The period in which the underlying cause for legal action occurred.
- c. The degree of probability of an unfavorable outcome.
- d. The amount or range of potential loss.

¹ This section supersedes the commentary, "Lawyers' Letters," January 1974 (section 1001), and auditing interpretations of section 560.12 on lawyers' letters, January 1975 (section 9560.01—26). It amends section 560.12(d) to read as follows: "Inquire of client's legal counsel concerning litigation, claims, and assessments (see section 337)."

² Pertinent portions are reprinted in Exhibit I, section 337B. FASB Statement No. 5 [AC section C59], also describes the standards of financial accounting and reporting for gain contingencies. The auditor's procedures with respect to gain contingencies are parallel to those described in this SAS for loss contingencies.

Audit Procedures

.05 Since the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

- a. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- b. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel, and obtain assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by Statement of Financial Accounting Standards No. 5 [AC section C59].
- c. Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.
- d. Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59]. Also the auditor, with the client's permission, should inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.³

.06 An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention. Accordingly, the auditor should request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

.07 The independent auditor's examination normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments. Examples of such procedures are as follows:

³ An example of a separate letter is as follows: We are writing to inform you that (name of company) has represented to us that (except as set forth below and excluding any such matters listed in the letter of audit inquiry) there are no unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59] in its financial statements at (balance sheet date) and for the (period) then ended. (List unasserted possible claims, if any.) Such a letter should be signed and sent by the auditor.

- a. Reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being examined.
- b. Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents.
- c. Obtaining information concerning guarantees from bank confirmation forms.
- d. Inspecting other documents for possible guarantees by the client.

Inquiry of a Client's Lawyer⁴

.08 A letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.⁵ Evidential matter obtained from the client's inside general counsel or legal department may provide the auditor with the necessary corroboration. However, evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish.

.09 The matters that should be covered in a letter of audit inquiry include, but are not limited to, the following:

- a. Identification of the company, including subsidiaries, and the date of the examination.
- b. A list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.
- c. A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome, with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.
- d. As to each matter listed in item b, a request that the lawyer either furnish the following information or comment on those matters as to which his views may differ from those stated by management, as appropriate:

⁴ An illustrative inquiry letter to legal counsel is contained in the Appendix (section 337A).

⁵ It is not intended that the lawyer be requested to undertake a reconsideration of all matters upon which he was consulted during the period under examination for the purpose of determining whether he can form a conclusion regarding the probability of assertion of any possible claim inherent in any of the matters so considered.

- (1) A description of the nature of the matter, the progress of the case to date, and the action the company intends to take (for example, to contest the matter vigorously or to seek an out-of-court settlement).
 - (2) An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.
 - (3) With respect to a list prepared by management, an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.
- e. As to each matter listed in item c, a request that the lawyer comment on those matters as to which his views concerning the description or evaluation of the matter may differ from those stated by management.
 - f. A statement by the client that the client understands that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client should disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5 [AC section C59].
 - g. A request that the lawyer confirm whether the understanding described in item f is correct.
 - h. A request that the lawyer specifically identify the nature of and reasons for any limitation on his response.

Inquiry need not be made concerning matters that are not considered material, provided the client and the auditor have reached an understanding on the limits of materiality for this purpose.

.10 In special circumstances, the auditor may obtain a response concerning matters covered by the audit inquiry letter in a conference, which offers an opportunity for a more detailed discussion and explanation than a written reply. A conference may be appropriate when the evaluation of the need for accounting for or disclosure of litigation, claims, and assessments involves such matters as the evaluation of the effect of legal advice concerning unsettled points of law, the effect of uncorroborated information, or other complex judgments. The auditor should appropriately document conclusions reached concerning the need for accounting for or disclosure of litigation, claims, and assessments.

.11 In some circumstances, a lawyer may be required by his Code of Professional Responsibility to resign his engagement if his advice concerning financial accounting and reporting for litigation, claims, and assessments is

disregarded by the client. When the auditor is aware that a client has changed lawyers or that a lawyer engaged by the client has resigned, the auditor should consider the need for inquiries concerning the reasons the lawyer is no longer associated with the client.

Limitations on the Scope of a Lawyer's Response⁶

.12 A lawyer may appropriately limit his response to matters to which he has given substantive attention in the form of legal consultation or representation. Also, a lawyer's response may be limited to matters that are considered individually or collectively material to the financial statements, provided the lawyer and auditor have reached an understanding on the limits of materiality for this purpose. Such limitations are not limitations on the scope of the auditor's examination.

.13 A lawyer's refusal to furnish the information requested in an inquiry letter either in writing or orally (see paragraphs .09 and .10) would be a limitation on the scope of the auditor's examination sufficient to preclude an unqualified opinion (see section 509.10—.11 in Appendix G).⁷ A lawyer's response to such an inquiry and the procedures set forth in paragraph .05 provide the auditor with sufficient evidential matter to satisfy himself concerning the accounting for and reporting of pending and threatened litigation, claims and assessments. The auditor obtains sufficient evidential matter to satisfy himself concerning reporting for those unasserted claims and assessments required to be disclosed in financial statements from the foregoing procedures and the lawyer's specific acknowledgement of his responsibility to his client in respect of disclosure obligations (see paragraph .09g). This approach with respect to unasserted claims and assessments is necessitated by the public interest in protecting the confidentiality of lawyer-client communications.

Other Limitations on a Lawyer's Response

.14 A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome may sometimes not be within a lawyer's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available; and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, a lawyer may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor ordinarily will conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event which is not susceptible of reasonable estimation. If the effect of the matter on the financial statements could be material, the auditor ordinarily will conclude that he is unable to express an unqualified opinion (see section 509.21—.26 in Appendix G).

[The next page is 389.]

⁶ The American Bar Association has approved a "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," which explains the concerns of lawyers and the nature of the limitations an auditor is likely to encounter. That Statement of Policy is reprinted as Exhibit II (section 337C) for the convenience of readers, but is not an integral part of this Statement.

⁷ A refusal to respond should be distinguished from an inability to form a conclusion with respect to certain matters of judgment (see paragraph .14). Also, lawyers outside the United States sometimes follow practices at variance with those contemplated by this section to the extent that different procedures from those outlined herein may be necessary. In such circumstances, the auditor should exercise judgment in determining whether alternative procedures are adequate to comply with the requirements of this section.

AU Section 337A

Appendix—Illustrative Audit Inquiry Letter to Legal Counsel

Source: SAS No. 12.

Issue date, unless otherwise indicated: January, 1976.

.01 In connection with an examination of our financial statements at (balance sheet date) and for the (period) then ended, management of the Company has prepared, and furnished to our auditors (name and address of auditors), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

Pending or Threatened Litigation (excluding unasserted claims)

[Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments (considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

[Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible

claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.]

AU Section 337B

Exhibit I—Excerpts from Statement of Financial Accounting Standards No. 5: Accounting for Contingencies

Source: SAS No. 12.

March, 1975.

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Introduction

1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss¹ (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. . . .

3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

- a) *Probable*. The future event or events are likely to occur.
- b) *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
- c) *Remote*. The chance of the future event or events occurring is slight. . . .

Standards of Financial Accounting and Reporting

Accrual of Loss Contingencies

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income³ if *both* of the following conditions are met:

¹ The term *loss* is used for convenience to include many charges against income that are commonly referred to as *expenses* and others that are commonly referred to as *losses*.

³ [Superseded, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.]

a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.⁴ It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b) The amount of loss can be reasonably estimated.

Disclosure of Loss Contingencies

9. Disclosure of the nature of an accrual⁵ made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.⁶ The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

11. After the date of an enterprise's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, e.g., an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, e.g., threat of expropriation of assets after the date of the financial statements or the filing for bankruptcy by an enterprise whose debt was guaranteed after the date of the financial statements. In none of the cases cited in this paragraph was an asset impaired or a liability incurred at the date of the financial statements, and the condition for accrual in paragraph 8(a) is, therefore, not met. Disclosure of those kinds of losses or loss contingencies may be necessary, however, to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements shall indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements where the amount of asset impairment or liability incurrence can be reasonably estimated, disclo-

⁴ *Date of the financial statements* means the end of the most recent accounting period for which financial statements are being presented.

⁵ Terminology used shall be descriptive of the nature of the accrual (see paragraphs 57—64 of *Accounting Terminology Bulletin No. 1*, "Review and Resume").

⁶ For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(a) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements.

sure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical financial statements. . . .

Litigation, Claims, and Assessments

33. The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

- a) The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.
- b) The degree of probability of an unfavorable outcome.
- c) The ability to make a reasonable estimate of the amount of loss.

34. As a condition for accrual of a loss contingency, paragraph 8(a) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for litigation, claims, or assessments whose underlying cause is an event or condition occurring after the date of financial statements but before those financial statements are issued, for example, a suit for damages alleged to have been suffered as a result of an accident that occurred after the date of the financial statements. Disclosure may be required, however, by paragraph 11.

35. On the other hand, accrual may be appropriate for litigation, claims, or assessments whose underlying cause is an event occurring on or before the date of an enterprise's financial statements even if the enterprise does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statements. If those financial statements have not been issued, accrual of a loss related to the litigation, claim, or assessment would be required if the probability of loss is such that the condition in paragraph 8(a) is met and the amount of loss can be reasonably estimated.

36. If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(a) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(a) is met.

37. The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(a) would be met if an unfavorable outcome is

determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement.

38. With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10.

39. As a condition for accrual of a loss contingency, paragraph 8(b) requires that the amount of loss can be reasonably estimated. In some cases, it may be determined that a loss was incurred because an unfavorable outcome of the litigation, claim, or assessment is probable (thus satisfying the condition in paragraph 8(a)), but the range of possible loss is wide. For example, an enterprise may be litigating an income tax matter. In preparation for the trial, it may determine that, based on recent decisions involving one aspect of the litigation, it is probable that it will have to pay additional taxes of \$2 million. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the enterprise may have to pay taxes of \$8 million over and above the \$2 million. In that case, paragraph 8 requires accrual of the \$2 million if that is considered a reasonable estimate of the loss. Paragraph 10 requires disclosure of the additional exposure to loss if there is a reasonable possibility that additional taxes will be paid. Depending on the circumstances, paragraph 9 may require disclosure of the \$2 million that was accrued.

[The next page is 397.]

AU Section 337C***Exhibit II—American Bar
Association Statement of
Policy Regarding Lawyers’
Responses to Auditors’
Requests for Information***

Source: SAS No. 12.

Preamble

The public interest in protecting the confidentiality of lawyer-client communications is fundamental. The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the “confidentiality” essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client’s ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

NOTE: This document, in the form herein set forth, was approved by the Board of Governors of the American Bar Association in December 1975, which official action permitted its release to lawyers and accountants as the standard recommended by the American Bar Association for the lawyer’s response to letters of audit inquiry.

It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.

Consistent with the foregoing public policy considerations, it is believed appropriate to distinguish between, on the one hand, litigation which is pending or which a third party has manifested to the client a present intention to commence and, on the other hand, other contingencies of a legal nature or having legal aspects. As regards the former category, unquestionably the lawyer representing the client in a litigation matter may be the best source for a description of the claim or claims asserted, the client's position (e.g., denial, contest, etc.), and the client's possible exposure in the litigation (to the extent the lawyer is in a position to do so). As to the latter category, it is submitted that, for the reasons set forth above, it is not in the public interest for the lawyer to be required to respond to general inquiries from auditors concerning possible claims.

It is recognized that the disclosure requirements for enterprises subject to the reporting requirements of the Federal securities laws are a major concern of managements and counsel, as well as auditors. It is submitted that compliance therewith is best assured when clients are afforded maximum encouragement, by protecting lawyer-client confidentiality, freely to consult counsel. Likewise, lawyers must be keenly conscious of the importance of their clients being competently advised in these matters.

Statement of Policy

NOW, THEREFORE, BE IT RESOLVED that it is desirable and in the public interest that this Association adopt the following Statement of Policy regarding the appropriate scope of the lawyer's response to the auditor's request, made by the client at the request of the auditor, for information concerning matters referred to the lawyer during the course of his representation of the client:

(1) *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5, promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying Commentary), to the extent hereinafter set forth, subject to the following:

(a) Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.

(b) In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the

evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.

(c) Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.

(d) In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

(2) *Limitation on Scope of Response.* It is appropriate for the lawyer to set forth in his response, by way of limitation, the scope of his engagement by the client. It is also appropriate for the lawyer to indicate the date as of which information is furnished and to disclaim any undertaking to advise the auditor of changes which may thereafter be brought to the lawyer's attention. *Unless the lawyer's response indicates otherwise, (a) it is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation and, where appropriate, legal representation since the beginning of the period or periods being reported upon, and (b) if a law firm or a law department, the auditor may assume that the firm or department has endeavored, to the extent believed necessary by the firm or department, to determine from lawyers currently in the firm or department who have performed services for the client since the beginning of the fiscal period under audit whether such services involved substantive attention in the form of legal consultation concerning those loss contingencies referred to in Paragraph 5(a) below but, beyond that, no review has been made of any of the client's transactions or other matters for the purpose of identifying loss contingencies to be described in the response.**

(3) *Response may be Limited to Material Items.* In response to an auditor's request for disclosure of loss contingencies of a client, it is appropriate for the lawyer's response to indicate that the response is limited to items which are considered individually or collectively material to the presentation of the client's financial statements.

(4) *Limited Responses.* Where the lawyer is limiting his response in accordance with the Statement of Policy, his response should so indicate (see Paragraph 8). If in any other respect the lawyer is not undertaking to respond to or comment on particular aspects of the inquiry when responding to the auditor, he should consider advising the auditor that his response is limited, in order to avoid any inference that the lawyer has responded to all aspects; otherwise, he may be assuming a responsibility which he does not intend.

(5) *Loss Contingencies.* When properly requested by the client, it is appropriate for the lawyer to furnish to the auditor information concerning the following matters if the lawyer has been engaged by the client to represent or advise the client professionally with respect thereto and he has devoted substantive attention to them in the form of legal representation or consultation:

(a) *overtly threatened or pending litigation*, whether or not specified by the client;

* As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

(b) a *contractually assumed obligation* which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor;

(c) an *unasserted possible claim or assessment* which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor.

With respect to clause (a), overtly threatened litigation means that a potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote. With respect to clause (c), where there has been no manifestation by a potential claimant of an awareness of and present intention to assert a possible claim or assessment, consistent with the considerations and concerns outlined in the Preamble and Paragraph 1 hereof, the client should request the lawyer to furnish information to the auditor only if the client has determined that it is probable that a possible claim will be asserted, that there is a reasonable possibility that the outcome (assuming such assertion) will be unfavorable, and that the resulting liability would be material to the financial condition of the client. Examples of such situations might (depending in each case upon the particular circumstances) include the following: (i) a catastrophe, accident or other similar physical occurrence in which the client's involvement is open and notorious, or (ii) an investigation by a government agency where enforcement proceedings have been instituted or where the likelihood that they will not be instituted is remote, under circumstances where assertion of one or more private claims for redress would normally be expected, or (iii) a public disclosure by the client acknowledging (and thus focusing attention upon) the existence of one or more probable claims arising out of an event or circumstance. In assessing whether or not the assertion of a possible claim is probable, it is expected that the client would normally employ, by reason of the inherent uncertainties involved and insufficiency of available data, concepts parallel to those used by the lawyer (discussed below) in assessing whether or not an unfavorable outcome is probable; thus, assertion of a possible claim would be considered probable only when the prospects of its being asserted seem reasonably certain (i.e., supported by extrinsic evidence strong enough to establish a presumption that it will happen) and the prospects of nonassertion seem slight.

It would not be appropriate, however, for the lawyer to be requested to furnish information in response to an inquiry letter or supplement thereto if it appears that (a) the client has been required to specify unasserted possible claims without regard to the standard suggested in the preceding paragraph, or (b) the client has been required to specify all or substantially all unasserted possible claims as to which legal advice may have been obtained, since, in either case, such a request would be in substance a general inquiry and would be inconsistent with the intent of this Statement of Policy.

The information that lawyers may properly give to the auditor concerning the foregoing matters would include (to the extent appropriate) an identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client.

In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote"; for purposes of any such judgment it is appropriate to use the following meanings:

(i) *probable*—an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.

(ii) *remote*—an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.

If, in the opinion of the lawyer, considerations within the province of his professional judgment bear on a particular loss contingency to the degree necessary to make an informed judgment, he may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is "probable" or "remote," applying the above meanings. No inference should be drawn, from the absence of such a judgment, that the client will not prevail.

The lawyer also may be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

The considerations bearing upon the difficulty in estimating loss (or range of loss) where pending litigation is concerned are obviously even more compelling in the case of unasserted possible claims. In most cases, the lawyer will not be able to provide any such estimate to the auditor.

As indicated in Paragraph 4 hereof, the auditor may assume that all loss contingencies specified by the client in the manner specified in clauses (b) and (c) above have received comment in the response, unless otherwise therein indicated. The lawyer should not be asked, nor need the lawyer undertake, to furnish information to the auditor concerning loss contingencies except as contemplated by this Paragraph 5.

(6) *Lawyer's Professional Responsibility.* Independent of the scope of his response to the auditor's request for information, the lawyer, depending upon the nature of the matters as to which he is engaged, may have as part of his professional responsibility to his client an obligation to advise the client concerning the need for or advisability of public disclosure of a wide range of events and circumstances. The lawyer has an obligation not knowingly to participate in any violation by the client of the disclosure requirements of the securities laws. In appropriate circumstances, the lawyer also may be required under the Code of Professional Responsibility to resign his engagement if his advice concerning disclosures is disregarded by the client. The auditor may properly assume that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements* of FAS 5.

* Under FAS 5, when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment, disclosure of an unasserted possible claim is required only if the enterprise concludes that (i) it is probable that a claim will be asserted, (ii) there is a

(7) *Limitation on Use of Response.* Unless otherwise stated in the lawyer's response, it shall be solely for the auditor's information in connection with his audit of the financial condition of the client and is not to be quoted in whole or in part or otherwise referred to in any financial statements of the client or related documents, nor is it to be filed with any governmental agency or other person, without the lawyer's prior written consent.[†] Notwithstanding such limitation, the response can properly be furnished to others in compliance with court process or when necessary in order to defend the auditor against a challenge of the audit by the client or a regulatory agency, provided that the lawyer is given written notice of the circumstances at least twenty days before the response is so to be furnished to others, or as long in advance as possible if the situation does not permit such period of notice. \†/

(8) *General.* This Statement of Policy, together with the accompanying Commentary (which is an integral part hereof), has been developed for the general guidance of the legal profession. In a particular case, the lawyer may elect to supplement or modify the approach hereby set forth. If desired, this Statement of Policy may be incorporated by reference in the lawyer's response by the following statement: "This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any 'loss contingencies' is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement)."

The accompanying Commentary is an integral part of this Statement of Policy.

Commentary

Paragraph 1 (Client Consent to Response)

In responding to any aspect of an auditor's inquiry letter, the lawyer must be guided by his ethical obligations as set forth in the Code of Professional Responsibility. Under Canon 4 of the Code of Professional Responsibility a lawyer is enjoined to preserve the client's confidences (defined as information protected by the attorney-client privilege under applicable law) and the client's secrets (defined as other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client). The observance of this ethical obligation, in the context of public policy, "... not only facilitates the full development of facts essential to proper representation of the client but also encourages laymen to seek early legal assistance." (Ethical Consideration 4-1).

(Footnote Continued)

reasonable possibility, if the claim is in fact asserted, that the outcome will be unfavorable, and (iii) the liability resulting from such unfavorable outcome would be material to its financial condition.

[†] As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

The lawyer's ethical obligation therefore includes a much broader range of information than that protected by the attorney-client privilege. As stated in Ethical Consideration 4-4: "The attorney-client privilege is more limited than the ethical obligation of a lawyer to guard the confidences and secrets of his client. This ethical precept, unlike the evidentiary privilege, exists without regard to the nature or source of information or the fact that others share the knowledge."

In recognition of this ethical obligation, the lawyer should be careful to disclose fully to his client any confidence, secret or evaluation that is to be revealed to another, including the client's auditor, and to satisfy himself that the officer or agent of a corporate client consenting to the disclosure understands the legal consequences thereof and has authority to provide the required consent.

The law in the area of attorney-client privilege and the impact of statements made in letters to auditors upon that privilege has not yet been developed. Based upon cases treating the attorney-client privilege in other contexts, however, certain generalizations can be made with respect to the possible impact of statements in letters to auditors.

It is now generally accepted that a corporation may claim the attorney-client privilege. Whether the privilege extends beyond the control group of the corporation (a concept found in the existing decisional authority), and if so, how far, is yet unresolved.

If a client discloses to a third party a part of any privileged communication he has made to his attorney, there may have been a waiver as to the whole communication; further, it has been suggested that giving accountants access to privileged statements made to attorneys may waive any privilege as to those statements. Any disclosure of privileged communications relating to a particular subject matter may have the effect of waiving the privilege on other communications with respect to the same subject matter.

To the extent that the lawyer's knowledge of unasserted possible claims is obtained by means of confidential communications from the client, any disclosure thereof might constitute a waiver as fully as if the communication related to pending claims.

A further difficulty arises with respect to requests for evaluation of either pending or unasserted possible claims. It might be argued that any evaluation of a claim, to the extent based upon a confidential communication with the client, waives any privilege with respect to that claim.

Another danger inherent in a lawyer's placing a value on a claim, or estimating the likely result, is that such a statement might be treated as an admission or might be otherwise prejudicial to the client.

The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between lawyers and auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.

Paragraph 2 (Limitation on Scope of Response)

In furnishing information to an auditor, the lawyer can properly limit himself to loss contingencies which he is handling on a substantive basis for the client in the form of legal consultation (advice and other attention to matters not in litigation by the lawyer in his professional capacity) or legal

representation (counsel of record or other direct professional responsibility for a matter in litigation). Some auditors' inquiries go further and ask for information on matters of which the lawyer "has knowledge." Lawyers are concerned that such a broad request may be deemed to include information coming from a variety of sources including social contact and thirdparty contacts as well as professional engagement and that the lawyer might be criticized or subjected to liability if some of this information is forgotten at the time of the auditor's request.

It is also believed appropriate to recognize that the lawyer will not necessarily have been authorized to investigate, or have investigated, all legal problems of the client, even when on notice of some facts which might conceivably constitute a legal problem upon exploration and development. Thus, consideration in the form of preliminary or passing advice, or regarding an incomplete or hypothetical state of facts, or where the lawyer has not been requested to give studied attention to the matter in question, would not come within the concept of "substantive attention" and would therefore be excluded. Similarly excluded are matters which may have been mentioned by the client but which are not actually being handled by the lawyer. Paragraph 2 undertakes to deal with these concerns.

Paragraph 2 is also intended to recognize the principle that the appropriate lawyer to respond as to a particular loss contingency is the lawyer having charge of the matter for the client (e.g., the lawyer representing the client in a litigation matter and/or the lawyer having overall charge and supervision of the matter), and that the lawyer not having that kind of role with respect to the matter should not be expected to respond merely because of having become aware of its existence in a general or incidental way.

The internal procedures to be followed by a law firm or law department may vary based on factors such as the scope of the lawyer's engagement and the complexity and magnitude of the client's affairs. Such procedures could, but need not, include use of a docket system to record litigation, consultation with lawyers in the firm or department having principal responsibility for the client's affairs or other procedures which, in light of the cost to the client, are not disproportionate the anticipated benefit to be derived. Although these procedures may not necessarily identify all matters relevant to the response, the evolution and application of the lawyer's customary procedures should constitute a reasonable basis for the lawyer's response.

As the lawyer's response is limited to matters involving his professional engagement as counsel, such response should not include information concerning the client which the lawyer receives in another role. In particular, a lawyer who is also a director or officer of the client would not include information which he received as a director or officer unless the information was also received (or, absent the dual role, would in the normal course be received) in his capacity as legal counsel in the context of his professional engagement. Where the auditor's request for information is addressed to a law firm as a firm, the law firm may properly assume that its response is not expected to include any information which may have been communicated to the particular individual by reason of his serving in the capacity of director or officer of the client. The question of the individual's duty, in his role as a director or officer, is not here addressed.

Paragraph 3 (Response May Cover only Material Items in Certain Cases)

Paragraph 3 makes it clear that the lawyer may optionally limit his responses to those items which are individually or collectively material to the

auditor's inquiry. If the lawyer takes responsibility for making a determination that a matter is not material for the purposes of his response to the audit inquiry, he should make it clear that his response is so limited. The auditor, in such circumstance, should properly be entitled to rely upon the lawyer's response as providing him with the necessary corroboration. It should be emphasized that the employment of inside general counsel by the client should not detract from the acceptability of his response since inside general counsel is as fully bound by the professional obligations and responsibilities contained in the Code of Professional Responsibility as outside counsel. If the audit inquiry sets forth a definition of materiality but the lawyer utilizes a different test of materiality, he should specifically so state. The lawyer may wish to reach an understanding with the auditor concerning the test of materiality to be used in his response, but he need not do so if he assumes responsibility for the criteria used in making materiality determinations. Any such understanding with the auditor should be referred to or set forth in the lawyer's response. In this connection, it is assumed that the test of materiality so agreed upon would not be so low in amount as to result in a disservice to the client and an unreasonable burden on counsel.

Paragraph 4 (Limited Responses)

The Statement of Policy is designed to recognize the obligation of the auditor to complete the procedures considered necessary to satisfy himself as to the fair presentation of the company's financial condition and results, in order to render a report which includes an opinion not qualified because of a limitation on the scope of the audit. In this connection, reference is made to SEC Accounting Series Release No. 90 [Financial Reporting Release No. 1, section 607.01(b)], in which it is stated:

"A 'subject to' or 'except for' opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The 'subject to' qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matters which cannot be resolved at statement date."

[The next page is 407.]

Paragraph 5 (Loss Contingencies)

Paragraph 5 of the Statement of Policy summarizes the categories of "loss contingencies" about which the lawyer may furnish information to the auditor. The term loss contingencies and the categories relate to concepts of accounting accrual and disclosure specified for the accounting profession in Statement of Financial Accounting Standards No. 5 ("FAS 5") issued by the Financial Accounting Standards Board in March, 1975.

5.1 Accounting Requirements

To understand the significance of the auditor's inquiry and the implications of any response the lawyer may give, the lawyer should be aware of the following accounting concepts and requirements set out in FAS 5:*

(a) A "loss contingency" is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more events occur or fail to occur. Resolutions of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability.

(Para. 1)

(b) When a "loss contingency" exists, the likelihood that a future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. There are three areas within that range, defined as follows:

(i) *Probable*—"The future event or events are likely to occur."

(ii) *Reasonably possible*—"The chance of the future event or events occurring is more than remote but less than likely."

(iii) *Remote*—"The chance of the future event or events occurring is slight."

(Para. 3)

(c) *Accrual* in a client's financial statements by a charge to income of the period will be required if *both* the following conditions are met:

(i) "Information available prior to issuance of the financial statements indicates that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be *probable* that one or more future events will occur confirming the fact of the loss." (emphasis added; footnote omitted)

(ii) "The amount of loss can be reasonably estimated."

(Para. 8)

(d) If there is no *accrual* of the loss contingency in the client's financial statements because one of the two conditions outlined in (c)

* Citations are to paragraph numbers of FAS 5.

above are not met, *disclosure* may be required as provided in the following:

"If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable." (emphasis added; footnote omitted)

(Para. 10)

(e) The accounting requirements recognize or specify that (i) the opinions or views of counsel are not the sole source of evidential matter in making determinations about the accounting recognition or treatment to be given to litigation, and (ii) the fact that the lawyer is not able to express an opinion that the outcome will be favorable does not necessarily require an accrual of a loss. Paragraphs 36 and 37 of FAS 5 state as follows:

"If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(a) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(a) is met.

"The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(a) would

be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement."

(f) Paragraph 38 of FAS 5 focuses on certain examples concerning the determination by the enterprise whether an assertion of an *unasserted possible claim* may be considered probable:

"With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10."

For a more complete presentation of FAS 5, reference is made to Exhibit I, section 337B, in which are set forth excerpts selected by the AICPA as relevant to a Statement on Auditing Standards, issued by its Auditing Standards Executive Committee, captioned "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments."

5.2 Lawyer's Response

Concepts of probability inherent in the usage of terms like "probable" or "reasonably possible" or "remote" mean different things in different contexts. Generally, the outcome of, or the loss which may result from, litigation cannot be assessed in any way that is comparable to a statistically or empirically determined concept of "probability" that may be applicable when

determining such matters as reserves for warranty obligations or accounts receivable or loan losses when there is a large number of transactions and a substantial body of known historical experience for the enterprise or comparable enterprises. While lawyers are accustomed to counseling clients during the progress of litigation as to the possible amount required for settlement purposes, the estimated risks of the proceedings at particular times and the possible application or establishment of points of law that may be relevant, such advice to the client is not possible at many stages of the litigation and may change dramatically depending upon the development of the proceedings. Lawyers do not generally quantify for clients the "odds" in numerical terms; if they do, the quantification is generally only undertaken in an effort to make meaningful, for limited purposes, a whole host of judgmental factors applicable at a particular time, without any intention to depict "probability" in any statistical, scientific or empirically-grounded sense. Thus, for example, statements that litigation is being defended vigorously and that the client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense.

Likewise, the "amount" of loss—that is, the total of costs and damages that ultimately might be assessed against a client—will, in most litigation, be a subject of wide possible variance at most stages; it is the rare case where the amount is precise and where the question is whether the client against which claim is made is liable either for all of it or none of it.

In light of the foregoing considerations, it must be concluded that, as a general rule, it should not be anticipated that meaningful quantifications of "probability" of outcome or amount of damages can be given by lawyers in assessing litigation. To provide content to the definitions set forth in Paragraph 5 of the Statement of Policy, this Commentary amplifies the meanings of the terms under discussion, as follows:

"probable"—An unfavorable outcome is normally "probable" if, but only if, investigation, preparation (including development of the factual data and legal research) and progress of the matter have reached a stage where a judgment can be made, taking all relevant factors into account which may affect the outcome, that it is extremely doubtful that the client will prevail.

"remote"—The prospect for an unfavorable outcome appears, at the time, to be slight; i.e., it is extremely doubtful that the client will not prevail. Normally, this would entail the ability to make an unqualified judgment, taking into account all relevant factors which may affect the outcome, that the client may confidently expect to prevail on a motion for summary judgment on all issues due to the clarity of the facts and the law.

In other words, for purposes of the lawyer's response to the request to advise auditors about litigation, an unfavorable outcome will be "probable" only if the chances of the client prevailing appear slight and of the claimant losing appear extremely doubtful; it will be "remote" when the client's chances of losing appear slight and of not winning appear extremely doubtful. It is, therefore, to be anticipated that, in most situations, an unfavorable

outcome will be neither "probable" nor "remote" as defined in the Statement of Policy.

The discussion above about the very limited basis for furnishing judgments about the outcome of litigation applies with even more force to a judgment concerning whether or not the assertion of a claim not yet asserted is "probable." That judgment will infrequently be one within the professional competence of lawyers and therefore the lawyer should not undertake such assessment except where such judgment may become meaningful because of the presence of special circumstances, such as catastrophes, investigations and previous public disclosure as cited in Paragraph 5 of the Statement of Policy, or similar extrinsic evidence relevant to such assessment. Moreover, it is unlikely, absent relevant extrinsic evidence, that the client or anyone else will be in a position to make an informed judgment that assertion of a possible claim is "probable" as opposed to "reasonably possible" (in which event disclosure is not required). In light of the legitimate concern that the public interest would not be well served by resolving uncertainties in a way that invites the assertion of claims or otherwise causes unnecessary harm to the client and its stockholders, a decision to treat an unasserted claim as "probable" of assertion should be based only upon compelling judgment.

Consistent with these limitations believed appropriate for the lawyer, he should not represent to the auditor, nor should any inference from his response be drawn, that the unasserted possible claims identified by the client (as contemplated by Paragraph 5(c) of the Statement of Policy) represent all such claims of which the lawyer may be aware or that he necessarily concurs in his client's determination of which unasserted possible claims warrant specification by the client; within proper limits, this determination is one which the client is entitled to make—and should make—and it would be inconsistent with his professional obligations for the lawyer to volunteer information arising from his confidential relationship with his client.

As indicated in Paragraph 5, the lawyer also may be asked to estimate the potential loss (or range) in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the lawyer would provide an estimate only if he believes that the probability of inaccuracy of the estimate of the range or amount is slight. What is meant here is that the estimate of amount of loss presents the same difficulty as assessment of outcome and that the same formulation of "probability" should be used with respect to the determination of estimated loss amounts as should be used with respect to estimating the outcome of the matter.

In special circumstances, with the proper consent of the client, the lawyer may be better able to provide the auditor with information concerning loss contingencies through conferences where there is opportunity for more detailed discussion and interchange. However, the principles set forth in the Statement of Policy and this Commentary are fully applicable to such conferences.

Subsumed throughout this discussion is the ongoing responsibility of the lawyer to assist his client, at the client's request, in complying with the

requirements of FAS 5 to the extent such assistance falls within his professional competence. This will continue to involve, to the extent appropriate, privileged discussions with the client to provide a better basis on which the client can make accrual and disclosure determinations in respect of its financial statements.

In addition to the considerations discussed above with respect to the making of any judgment or estimate by the lawyer in his response to the auditor, including with respect to a matter specifically identified by the client, the lawyer should also bear in mind the risk that the furnishing of such a judgment or estimate to any one other than the client might constitute an admission or be otherwise prejudicial to the client's position in its defense against such litigation or claim (see Paragraph 1 of the Statement of Policy and of this Commentary).

Paragraph 6 (Lawyer's Professional Responsibility)

The client must satisfy whatever duties it has relative to timely disclosure, including appropriate disclosure concerning material loss contingencies, and, to the extent such matters are given substantive attention in the form of legal consultation, the lawyer, when his engagement is to advise his client concerning a disclosure obligation, has a responsibility to advise his client concerning its obligations in this regard. Although lawyers who normally confine themselves to a legal specialty such as tax, antitrust, patent or admiralty law, unlike lawyers consulted about SEC or general corporate matters, would not be expected to advise generally concerning the client's disclosure obligations in respect of a matter on which the lawyer is working, the legal specialist should counsel his client with respect to the client's obligations under FAS 5 to the extent contemplated herein. Without regard to legal specialty, the lawyer should be mindful of his professional responsibility to the client described in Paragraph 6 of the Statement of Policy concerning disclosure.

The lawyer's responsibilities with respect to his client's disclosure obligations have been a subject of considerable discussion and there may be, in due course, clarification and further guidance in this regard. In any event, where in the lawyer's view it is clear that (i) the matter is of material importance and seriousness, and (ii) there can be no reasonable doubt that its non-disclosure in the client's financial statements would be a violation of law giving rise to material claims, rejection by the client of his advice to call the matter to the attention of the auditor would almost certainly require the lawyer's withdrawal from employment in accordance with the Code of Professional Responsibility. (See, e.g., Disciplinary Rule 7-102 (A)(3) and (7), and Disciplinary Rule 2-110 (B)(2).) Withdrawal under such circumstances is obviously undesirable and might present serious problems for the client. Accordingly, in the context of financial accounting and reporting for loss contingencies arising from unasserted claims, the standards for which are contained in FAS 5, clients should be urged to disclose to the auditor information concerning an unasserted possible claim or assessment (not

otherwise specifically identified by the client) where in the course of the services performed for the client it has become clear to the lawyer that (i) the client has no reasonable basis to conclude that assertion of the claim is not probable (employing the concepts hereby enunciated) and (ii) given the probability of assertion, disclosure of the loss contingency in the client's financial statements is beyond reasonable dispute required.

Paragraph 7 (Limitation on Use of Response)

Some inquiry letters make specific reference to, and one might infer from others, an intention to quote verbatim or include the substance of the lawyer's reply in footnotes to the client's financial statements. Because the client's prospects in pending litigation may shift as a result of interim developments, and because the lawyer should have an opportunity, if quotation is to be made, to review the footnote in full, it would seem prudent to limit the use of the lawyer's reply letter. Paragraph 7 sets out such a limitation.

Paragraph 7 also recognizes that it may be in the client's interest to protect information contained in the lawyer's response to the auditor, if and to the extent possible, against unnecessary further disclosure or use beyond its intended purpose of informing the auditor. For example, the response may contain information which could prejudice efforts to negotiate a favorable settlement of a pending litigation described in the response. The requirement of consent to further disclosure, or of reasonable advance notice where disclosure may be required by court process or necessary in defense of the audit, is designed to give the lawyer an opportunity to consult with the client as to whether consent should be refused or limited or, in the case of legal process or the auditor's defense of the audit, as to whether steps can and should be taken to challenge the necessity of further disclosure or to seek protective measures in connection therewith. It is believed that the suggested standard of twenty days advance notice would normally be a minimum reasonable time for this purpose.

Paragraph 8 (General)

It is reasonable to assume that the Statement of Policy will receive wide distribution and will be readily available to the accounting profession. Specifically, the Statement of Policy has been reprinted as Exhibit II to the Statement on Auditing Standards, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," issued by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants. Accordingly, the mechanic for its incorporation by reference will facilitate lawyer-auditor communication. The incorporation is intended to include not only limitations, such as those provided by Paragraphs 2 and 7 of the Statement of Policy, but also the explanatory material set forth in this Commentary.

Annex A

[Illustrative forms of letters for full response by outside practitioner or law firm and inside general counsel to the auditor's inquiry letter. These illustrative forms, which are not part of the Statement of Policy, have been prepared by the Committee on Audit Inquiry Responses solely in order to assist those who may wish to have, for reference purposes, a form of response which incorporates the principles of the Statement of Policy and accompanying Commentary. Other forms of response letters will be appropriate depending on the circumstances.]

Illustrative form of letter for use by outside practitioner or law firm:

[Name and Address of Accounting Firm]

Re: [Name of Client] [and Subsidiaries]

Dear Sirs:

By letter dated *[insert date of request]* Mr. *[insert name and title of officer signing request]* of *[insert name of client]* [(the "Company") or (together with its subsidiaries, the "Company")]) has requested us to furnish you with certain information in connection with your examination of the accounts of the Company as at *[insert fiscal year-end]*.

[Insert description of the scope of the lawyer's engagement; the following are sample descriptions:]

While this firm represents the Company on a regular basis, our engagement has been limited to specific matters as to which we were consulted by the Company.

[or]

We call your attention to the fact that this firm has during the past year represented the Company only in connection with certain *[Federal income tax matters]* *[litigation]* *[real estate transactions]* *[describe other specific matters, as appropriate]* and has not been engaged for any other purpose.

Subject to the foregoing and to the last paragraph of this letter, we advise you that since *[insert date of beginning of fiscal period under audit]* we have not been engaged to give substantive attention to, or represent the Company in connection with, *[material]** loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If the inquiry letter requests information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations:]

* NOTE: See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

With respect to the matters specifically identified in the Company's letter and upon which comment has been specifically requested, as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, we advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] [as of *[insert date]*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and we disclaim any undertaking to advise you of changes which thereafter may be brought to our attention.

[Insert information with respect to outstanding bills for services and disbursements.]

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement]

Very truly yours,

Illustrative form of letter for use by inside general counsel:

[Name and Address of Accounting Firm]

Re: [Name of Company] [and Subsidiaries]

Dear Sirs:

As General Counsel* of [insert name of client] [(the "Company")]
[(together with its subsidiaries, the "Company")], I advise you as follows in
connection with your examination of the accounts of the Company as at
[insert fiscal year-end].

I call your attention to the fact that as General Counsel* for the Company
I have general supervision of the Company's legal affairs. *[If the general legal
supervisory responsibilities of the person signing the letter are limited, set
forth here a clear description of those legal matters over which such person
exercises general supervision, indicating exceptions to such supervision and
situations where primary reliance should be placed on other sources.]* In such
capacity, I have reviewed litigation and claims threatened or asserted
involving the Company and have consulted with outside legal counsel with
respect thereto where I have deemed appropriate.

Subject to the foregoing and to the last paragraph of this letter, I advise
you that since [insert date of beginning of fiscal period under audit] neither I,
nor any of the lawyers over whom I exercise general legal supervision, have
given substantive attention to, or represented the Company in connection
with, [material]** loss contingencies coming within the scope of clause (a) of
Paragraph 5 of the Statement of Policy referred to in the last paragraph of
this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If information concerning specified unasserted possible claims or
assessments and/or contractually assumed obligations is to be supplied:]

With respect to matters which have been specifically identified as
contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of
Policy, I advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [[as of the date of this letter] as of
[insert date], the date on which we commenced our internal review procedures
for purposes of preparing this response], except as otherwise noted, and I
disclaim any undertaking to advise you of changes which thereafter may be
brought to my attention or to the attention of the lawyers over whom I
exercise general legal supervision.

* It may be appropriate in some cases for the response to be given by inside counsel other
than inside general counsel in which event this letter should be appropriately modified.

** NOTE: See Paragraph 3 of the Statement of Policy and the accompanying Commentary
for guidance where the response is limited to material items.

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,

→ *The next page is 431.* ←

AU Section 339

Working Papers

(Supersedes Statement on Auditing Standards No. 1, section 338, "Working Papers.")¹

Source: SAS No. 41.

Issue date, unless otherwise indicated: April 1, 1982.

.01 The auditor should prepare and maintain working papers, the form and content of which should be designed to meet the circumstances of a particular engagement.² The information contained in working papers constitutes the principal record of the work that the auditor has done and the conclusions that he has reached concerning significant matters.³

Functions and Nature of Working Papers

.02 Working papers serve mainly to—

- a. Provide the principal support for the auditor's report, including his representation regarding observance of the standards of field work, which is implicit in the reference in his report to generally accepted auditing standards.
- b. Aid the auditor in the conduct and supervision of the engagement.

.03 Working papers are records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement. Examples of working papers are audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor. Working papers also may be in the form of data stored on tapes, films, or other media.

¹ This section amends section 230, *Due Care in the Performance of Work*, paragraph .04, by deleting the second sentence of that paragraph.

² This section does not modify the guidance in other Statements on Auditing Standards, including the following:

- The letter of audit inquiry to the client's lawyer required by section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, paragraphs .08—.09, or the documentation required by paragraph .10 when a response to the audit inquiry letter is received in a conference
- The written representations from management required by section 333, *Client Representations*
- The notation in the working papers required by section 323, *Required Communication of Material Weaknesses in Internal Accounting Control*, paragraph .04 (see Appendix G), if material weaknesses in internal accounting control are communicated orally to senior management or its board of directors
- The written audit program or set of written audit programs required by section 311, *Planning and Supervision*, paragraph .05
- The representation letter from a successor auditor required by section 711, *Filings Under Federal Securities Statutes*, paragraph .11b, when an auditor has examined the financial statements for prior periods but has not examined the financial statements for the most recent audited period included in a registration statement

³ However, there is no intention to imply that the auditor would be precluded from supporting his report by other means in addition to working papers.

.04 Factors affecting the auditor's judgment about the quantity, type, and content of the working papers for a particular engagement include (a) the nature of the engagement, (b) the nature of the auditor's report, (c) the nature of the financial statements, schedules, or other information on which the auditor is reporting, (d) the nature and condition of the client's records, (e) the degree of reliance on internal accounting control, and (f) the needs in the particular circumstances for supervision and review of the work.

Content of Working Papers

.05 The quantity, type, and content of working papers vary with the circumstances (see paragraph .04), but they should be sufficient to show that the accounting records agree or reconcile with the financial statements or other information reported on and that the applicable standards of field work have been observed. Working papers ordinarily should include documentation showing that—

- a. The work has been adequately planned and supervised, indicating observance of the first standard of field work.
- b. The system of internal accounting control has been studied and evaluated to the degree necessary to determine whether, and to what extent, other auditing procedures are to be restricted, indicating observance of the second standard of field work.
- c. The audit evidence obtained, the auditing procedures applied, and the testing performed have provided sufficient competent evidential matter to afford a reasonable basis for an opinion, indicating observance of the third standard of field work.

Ownership and Custody of Working Papers

.06 Working papers are the property of the auditor, and some states have statutes that designate the auditor as the owner of the working papers. The auditor's rights of ownership, however, are subject to ethical limitations relating to the confidential relationship with clients.

.07 Certain of the auditor's working papers may sometimes serve as a useful reference source for his client, but the working papers should not be regarded as a part of, or a substitute for, the client's accounting records.

.08 The auditor should adopt reasonable procedures for safe custody of his working papers and should retain them for a period sufficient to meet the needs of his practice and to satisfy any pertinent legal requirements of records retention.

Effective Date

.09 This section is effective for engagements beginning after May 31, 1982.

[The next page is 451.]

AU Section 341

The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern

(Supersedes section 340 [See Appendix G])

Source: SAS No. 59.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section provides guidance to the auditor in conducting an audit of financial statements in accordance with generally accepted auditing standards with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern.^{1, 2} Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions.

The Auditor's Responsibility

.02 The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited (hereinafter referred to as a *reasonable period of time*). The auditor's evaluation is based on his knowledge of relevant conditions and events that exist at or have occurred prior to the completion of fieldwork. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, as described in section 326, *Evidential Matter*.

¹ This section does not apply to an audit of financial statements based on the assumption of liquidation (for example, when [a] an entity is in the process of liquidation, [b] the owners have decided to commence dissolution or liquidation, or [c] legal proceedings, including bankruptcy, have reached a point at which dissolution or liquidation is probable). See Auditing Interpretation, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" (section 9508.33—38).

² The guidance provided in this section applies to audits of financial statements prepared either in accordance with generally accepted accounting principles or in accordance with a comprehensive basis of accounting other than generally accepted accounting principles. References in this section to generally accepted accounting principles are intended to include a comprehensive basis of accounting other than generally accepted accounting principles (excluding liquidation basis).

.03 The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:

- a. The auditor considers whether the results of his procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. It may be necessary to obtain additional information about such conditions and events, as well as the appropriate evidential matter to support information that mitigates the auditor's doubt.
- b. If the auditor believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, he should (1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and (2) assess the likelihood that such plans can be effectively implemented.
- c. After the auditor has evaluated management's plans, he concludes whether he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph (following the opinion paragraph) in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he should consider the need for disclosure.

.04 The auditor is not responsible for predicting future conditions or events. The fact that the entity may cease to exist as a going concern subsequent to receiving a report from the auditor that does not refer to substantial doubt, even within one year following the date of the financial statements, does not, in itself, indicate inadequate performance by the auditor. Accordingly, the absence of reference to substantial doubt in an auditor's report should not be viewed as providing assurance as to an entity's ability to continue as a going concern.

Audit Procedures

.05 It is not necessary to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose. The following are examples of procedures that may identify such conditions and events:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading of minutes of meetings of stockholders, board of directors, and important committees of the board

- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support

Consideration of Conditions and Events

.06 In performing audit procedures such as those presented in paragraph .05, the auditor may identify information about certain conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The following are examples of such conditions and events:

- *Negative trends*—for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios
- *Other indications of possible financial difficulties*—for example, default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, noncompliance with statutory capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets
- *Internal matters*—for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, need to significantly revise operations
- *External matters that have occurred*—for example, legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; uninsured or underinsured catastrophe such as a drought, earthquake, or flood

Consideration of Management's Plans

.07 If, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, he should consider management's plans for dealing with the adverse effects of the conditions and events. The auditor should obtain information about the plans and consider whether it is likely the adverse effects will be mitigated for a reasonable period of time and that such plans can be effectively implemented. The auditor's considerations relating to management plans may include the following:

- Plans to dispose of assets
 - Restrictions on disposal of assets, such as covenants limiting such transactions in loan or similar agreements or encumbrances against assets
 - Apparent marketability of assets that management plans to sell
 - Possible direct or indirect effects of disposal of assets

- Plans to borrow money or restructure debt
 - Availability of debt financing, including existing or committed credit arrangements, such as lines of credit or arrangements for factoring receivables or sale-leaseback of assets
 - Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity
 - Possible effects on management's borrowing plans of existing restrictions on additional borrowing or the sufficiency of available collateral
- Plans to reduce or delay expenditures
 - Apparent feasibility of plans to reduce overhead or administrative expenditures, to postpone maintenance or research and development projects, or to lease rather than purchase assets
 - Possible direct or indirect effects of reduced or delayed expenditures
- Plans to increase ownership equity
 - Apparent feasibility of plans to increase ownership equity, including existing or committed arrangements to raise additional capital
 - Existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investors

.08 When evaluating management's plans, the auditor should identify those elements that are particularly significant to overcoming the adverse effects of the conditions and events and should plan and perform auditing procedures to obtain evidential matter about them. For example, the auditor should consider the adequacy of support regarding the ability to obtain additional financing or the planned disposal of assets.

.09 When prospective financial information is particularly significant to management's plans, the auditor should request management to provide that information and should consider the adequacy of support for significant assumptions underlying that information. The auditor should give particular attention to assumptions that are—

- Material to the prospective financial information.
- Especially sensitive or susceptible to change.
- Inconsistent with historical trends.

The auditor's consideration should be based on knowledge of the entity, its business, and its management and should include (a) reading of the prospective financial information and the underlying assumptions and (b) comparing prospective financial information in prior periods with actual results and comparing prospective information for the current period with results achieved to date. If the auditor becomes aware of factors, the effects of which are not reflected in such prospective financial information, he should discuss those factors with management and, if necessary, request revision of the prospective financial information.

Consideration of Financial Statement Effects

.10 When, after considering management's plans, the auditor concludes there is substantial doubt about the entity's ability to continue as a going

concern for a reasonable period of time, the auditor should consider the possible effects on the financial statements and the adequacy of the related disclosure. Some of the information that might be disclosed includes—

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- The possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible discontinuance of operations.
- Management's plans (including relevant prospective financial information).³
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

.11 When, primarily because of the auditor's consideration of management's plans, he concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time is alleviated, he should consider the need for disclosure of the principal conditions and events that initially caused him to believe there was substantial doubt. The auditor's consideration of disclosure should include the possible effects of such conditions and events, and any mitigating factors, including management's plans.

Consideration of the Effects on the Auditor's Report

.12 If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion.⁴

.13 An example follows of an explanatory paragraph (following the opinion paragraph) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

.14 If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse

³ It is not intended that such prospective financial information constitute prospective financial statements meeting the minimum presentation guidelines set forth in the Statement on Standards for Accountants' Services on Prospective Financial Information, *Financial Forecasts and Projections* [section 2100], nor that the inclusion of such information require any consideration beyond that normally required by generally accepted auditing standards.

⁴ The inclusion of an explanatory paragraph (following the opinion paragraph) in the auditor's report contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (see paragraph .10), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (see section 508, *Reports on Audited Financial Statements*).

opinion. Reporting guidance for such situations is provided in section 508, *Reports on Audited Financial Statements*.

.15 Substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time that arose in the current period does not imply that a basis for such doubt existed in the prior period and, therefore, should not affect the auditor's report on the financial statements of the prior period that are presented on a comparative basis. When financial statements of one or more prior periods are presented on a comparative basis with financial statements of the current period, reporting guidance is provided in section 508.

.16 If substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time existed at the date of prior period financial statements that are presented on a comparative basis, and that doubt has been removed in the current period, the explanatory paragraph included in the auditor's report (following the opinion paragraph) on the financial statements of the prior period should not be repeated.

Effective Date

.17 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

AU Section 342

Auditing Accounting Estimates

Source: SAS No. 57.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with generally accepted auditing standards. For purposes of this section, an *accounting estimate* is an approximation of a financial statement element, item, or account. Accounting estimates are often included in historical financial statements because—

- a. The measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events.
- b. Relevant data concerning events that have already occurred cannot be accumulated on a timely, cost-effective basis.

.02 Accounting estimates in historical financial statements measure the effects of past business transactions or events, or the present status of an asset or liability. Examples of accounting estimates include net realizable values of inventory and accounts receivable, property and casualty insurance loss reserves, revenues from contracts accounted for by the percentage-of-completion method, and pension and warranty expenses.¹

.03 Management is responsible for making the accounting estimates included in the financial statements. Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.

.04 The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors.

¹ Additional examples of accounting estimates included in historical financial statements are presented in paragraph .16.

Developing Accounting Estimates

.05 Management is responsible for establishing a process for preparing accounting estimates. Although the process may not be documented or formally applied, it normally consists of—

- a. Identifying situations for which accounting estimates are required.
- b. Identifying the relevant factors that may affect the accounting estimate.
- c. Accumulating relevant, sufficient, and reliable data on which to base the estimate.
- d. Developing assumptions that represent management's judgment of the most likely circumstances and events with respect to the relevant factors.
- e. Determining the estimated amount based on the assumptions and other relevant factors.
- f. Determining that the accounting estimate is presented in conformity with applicable accounting principles and that disclosure is adequate.

The risk of material misstatement of accounting estimates normally varies with the complexity and subjectivity associated with the process, the availability and reliability of relevant data, the number and significance of assumptions that are made, and the degree of uncertainty associated with the assumptions.

Internal Control Structure Related to Accounting Estimates

.06 An entity's internal control structure may reduce the likelihood of material misstatements of accounting estimates. Specific relevant aspects of that structure include the following:

- a. Management communication of the need for proper accounting estimates
- b. Accumulation of relevant, sufficient, and reliable data on which to base an accounting estimate
- c. Preparation of the accounting estimate by qualified personnel
- d. Adequate review and approval of the accounting estimates by appropriate levels of authority, including—
 1. Review of sources of relevant factors
 2. Review of development of assumptions
 3. Review of reasonableness of assumptions and resulting estimates
 4. Consideration of the need to use the work of specialists
 5. Consideration of changes in previously established methods to arrive at accounting estimates
- e. Comparison of prior accounting estimates with subsequent results to assess the reliability of the process used to develop estimates
- f. Consideration by management of whether the resulting accounting estimate is consistent with the operational plans of the entity.

Evaluating Accounting Estimates

.07 The auditor's objective when evaluating accounting estimates is to obtain sufficient competent evidential matter to provide reasonable assurance that—

- a. All accounting estimates that could be material to the financial statements have been developed.
- b. Those accounting estimates are reasonable in the circumstances.
- c. The accounting estimates are presented in conformity with applicable accounting principles² and are properly disclosed.³

Identifying Circumstances That Require Accounting Estimates

.08 In evaluating whether management has identified all accounting estimates that could be material to the financial statements, the auditor considers the circumstances of the industry or industries in which the entity operates, its methods of conducting business, new accounting pronouncements, and other external factors. The auditor should consider performing the following procedures:

- a. Consider assertions embodied in the financial statements to determine the need for estimates. (See paragraph .16 for examples of accounting estimates included in financial statements.)
- b. Evaluate information obtained in performing other procedures, such as—
 1. Information about changes made or planned in the entity's business, including changes in operating strategy, and the industry in which the entity operates that may indicate the need to make an accounting estimate (section 311, *Planning and Supervision*).
 2. Changes in the methods of accumulating information.
 3. Information concerning identified litigation, claims, and assessments (section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*), and other contingencies.
 4. Information from reading available minutes of meetings of stockholders, directors, and appropriate committees.
 5. Information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies.
- c. Inquire of management about the existence of circumstances that may indicate the need to make an accounting estimate.

Evaluating Reasonableness

.09 In evaluating the reasonableness of an estimate, the auditor normally concentrates on key factors and assumptions that are—

² Section 411, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, discusses the auditor's responsibility for evaluating conformity with generally accepted accounting principles.

³ Section 431, *Adequacy of Disclosure in Financial Statements*, discusses the auditor's responsibility to consider whether the financial statements include adequate disclosures of material matters in light of the circumstances and facts of which he is aware.

- a. Significant to the accounting estimate.
- b. Sensitive to variations.
- c. Deviations from historical patterns.
- d. Subjective and susceptible to misstatement and bias.

The auditor normally should consider the historical experience of the entity in making past estimates as well as the auditor's experience in the industry. However, changes in facts, circumstances, or entity's procedures may cause factors different from those considered in the past to become significant to the accounting estimate.⁴

.10 In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

- a. Review and test the process used by management to develop the estimate.
- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- c. Review subsequent events or transactions occurring prior to completion of fieldwork.

.11 Review and test management's process. In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may consider performing when using this approach:

- a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.
- b. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.
- c. Consider whether there are additional key factors or alternative assumptions about the factors.
- d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
- e. Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose.
- f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.
- g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions.

⁴ In addition to other evidential matter about the estimate, in certain instances, the auditor may wish to obtain written representation from management regarding the key factors and assumptions.

- h. Consider using the work of a specialist regarding certain assumptions (section 336, *Using the Work of a Specialist*).
- i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.

.12 *Develop an expectation.* Based on the auditor's understanding of the facts and circumstances, he may independently develop an expectation as to the estimate by using other key factors or alternative assumptions about those factors.

.13 *Review subsequent events or transactions.* Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the completion of fieldwork, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness.

.14 As discussed in section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .29, the auditor evaluates the reasonableness of accounting estimates in relationship to the financial statements taken as a whole:

Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely error. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he should treat the difference between that estimate and the closest reasonable estimate as a likely error and aggregate it with other likely errors. The auditor should also consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole.

Effective Date

.15 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

Appendix

.16 Examples of Accounting Estimates

The following are examples of accounting estimates that are included in financial statements. The list is presented for information only. It should not be considered all-inclusive.

Receivables:

- Uncollectible receivables
- Allowance for loan losses
- Uncollectible pledges

Inventories:

- Obsolete inventory
- Net realizable value of inventories where future selling prices and future costs are involved
- Losses on purchase commitments

Financial instruments:

- Valuation of securities
- Trading versus investment security classification
- Probability of high correlation of a hedge
- Sales of securities with puts and calls

Productive facilities, natural resources and intangibles:

- Useful lives and residual values
- Depreciation and amortization methods
- Recoverability of costs
- Recoverable reserves

Accruals:

- Property and casualty insurance-company loss reserves
- Compensation in stock option plans and deferred plans
- Warranty claims
- Taxes on real and personal property
- Renegotiation refunds
- Actuarial assumptions in pension costs

Revenues:

- Airline passenger revenue
- Subscription income
- Freight and cargo revenue
- Dues income
- Losses on sales contracts

Contracts:

- Revenue to be earned
- Costs to be incurred
- Percent of completion

Leases:

- Initial direct costs
- Executory costs
- Residual values

Litigation:

- Probability of loss
- Amount of loss

Rates:

- Annual effective tax rate in interim reporting
- Imputed interest rates on receivables and payables
- Gross profit rates under program method of accounting

Other:

- Losses and net realizable value on disposal of segment or restructuring of a business
- Fair values in nonmonetary exchanges
- Interim period costs in interim reporting
- Current values in personal financial statements

AU Section 350

Audit Sampling

(Supersedes Statement on Auditing Standards No. 1, sections 320A, and 320B.)

Sources: SAS No. 39; SAS No. 43; SAS No. 45.

See section 9350 for interpretations of this section.

Effective for periods ended on or after June 25, 1983, unless otherwise indicated.

.01 Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.¹ This section provides guidance for planning, performing, and evaluating audit samples.

.02 The auditor often is aware of account balances and transactions that may be more likely to contain errors.² He considers this knowledge in planning his procedures, including audit sampling. The auditor usually will have no special knowledge about other account balances and transactions that, in his judgment, will need to be tested to fulfill his audit objectives. Audit sampling is especially useful in these cases.

.03 There are two general approaches to audit sampling: nonstatistical and statistical. Both approaches require that the auditor use professional judgment in planning, performing, and evaluating a sample and in relating the evidential matter produced by the sample to other evidential matter when forming a conclusion about the related account balance or class of transactions. The guidance in this section applies equally to nonstatistical and statistical sampling.

.04 The third standard of field work states, "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination." Either approach to audit sampling, when properly applied, can provide sufficient evidential matter.

.05 The sufficiency of evidential matter is related to the design and size of an audit sample, among other factors. The size of a sample necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. For a given objective, the efficiency of the sample relates to its design; one sample is more efficient than another if it can achieve

¹ There may be other reasons for an auditor to examine less than 100 percent of the items comprising an account balance or class of transactions. For example, an auditor may examine only a few transactions from an account balance or class of transactions to (a) gain an understanding of the nature of an entity's operations or (b) clarify his understanding of the design of the entity's internal accounting control system. In such cases, the guidance in this statement is not applicable.

² For purposes of this section, errors includes both errors and irregularities as defined in section 327, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities* (see Appendix G).

the same objectives with a smaller sample size. In general, careful design can produce more efficient samples.

.06 Evaluating the competence of evidential matter is solely a matter of auditing judgment and is not determined by the design and evaluation of an audit sample. In a strict sense, the sample evaluation relates only to the likelihood that existing monetary errors or deviations from prescribed procedures are proportionately included in the sample, not to the auditor's treatment of such items. Thus, the choice of nonstatistical or statistical sampling does not directly affect the auditor's decisions about the auditing procedures to be applied, the competence of the evidential matter obtained with respect to individual items in the sample, or the actions that might be taken in light of the nature and cause of particular errors.

Uncertainty and Audit Sampling

.07 Some degree of uncertainty is implicit in the concept of "a reasonable basis for an opinion" referred to in the third standard of field work. The justification for accepting some uncertainty arises from the relationship between such factors as the cost and time required to examine all of the data and the adverse consequences of possible erroneous decisions based on the conclusions resulting from examining only a sample of the data. If these factors do not justify the acceptance of some uncertainty, the only alternative is to examine all of the data. Since this is seldom the case, the basic concept of sampling is well established in auditing practice.

.08 For purposes of this section, the uncertainty inherent in applying auditing procedures will be referred to as *audit risk*. Audit risk is a combination of the risk that material errors will occur in the accounting process used to develop the financial statements and the risk that any material errors that occur will not be detected by the auditor. The risk of these adverse events occurring jointly can be viewed as the product of the respective individual risks. The auditor may rely on internal accounting control to reduce the first risk and on substantive tests (tests of details of transactions and balances and analytical review procedures) to reduce the second risk. [As amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

.09 Audit risk includes both uncertainties due to sampling and uncertainties due to factors other than sampling. These aspects of audit risk are sampling risk and nonsampling risk, respectively. [As amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

.10 Sampling risk arises from the possibility that, when a compliance or a substantive test is restricted to a sample, the auditor's conclusions may be different from the conclusions he would reach if the test were applied in the same way to all items in the account balance or class of transactions. That is, a particular sample may contain proportionately more or less monetary errors or compliance deviations than exist in the balance or class as a whole. For a sample of a specific design, sampling risk varies inversely with sample size: the smaller the sample size, the greater the sampling risk.

.11 Nonsampling risk includes all the aspects of audit risk that are not due to sampling. An auditor may apply a procedure to all transactions or balances and still fail to detect a material misstatement or a material internal accounting control weakness. Nonsampling risk includes the possibility of selecting audit procedures that are not appropriate to achieve the specific objective. For example, confirming recorded receivables cannot be relied on to reveal unrecorded receivables. Nonsampling risk also arises because the auditor may fail to recognize errors included in documents that he examines, which

would make that procedure ineffective even if he were to examine *all* items. The risk of nonsampling error can be reduced to a negligible level through such factors as adequate planning and supervision (see section 311, *Planning and Supervision*) and proper conduct of a firm's audit practice (see section 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*). [As amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

Sampling Risk

.12 The auditor should apply professional judgment in assessing sampling risk. In performing substantive tests of details the auditor is concerned with two aspects of sampling risk:

- *The risk of incorrect acceptance* is the risk that the sample supports the conclusion that the recorded account balance is not materially misstated when it is materially misstated.
- *The risk of incorrect rejection* is the risk that the sample supports the conclusion that the recorded account balance is materially misstated when it is not materially misstated.

The auditor is also concerned with two aspects of sampling risk in performing compliance tests of internal accounting control:

- *The risk of overreliance* on internal accounting control is the risk that the sample supports the auditor's planned degree of reliance on the control when the true compliance rate does not justify such reliance.
- *The risk of underreliance* on internal accounting control is the risk that the sample does not support the auditor's planned degree of reliance on the control when the true compliance rate supports such reliance.

.13 The risk of incorrect rejection and the risk of underreliance on internal accounting control relate to the efficiency of the audit. For example, if the auditor's evaluation of an audit sample leads him to the initial erroneous conclusion that a balance is materially misstated when it is not, the application of additional audit procedures and consideration of other audit evidence would ordinarily lead the auditor to the correct conclusion. Similarly, if the auditor's evaluation of a sample leads him to unnecessarily reduce his planned degree of reliance on internal accounting control, he would ordinarily increase the scope of substantive tests to compensate for the perceived inability to rely on internal accounting control to the extent originally planned. Although the audit may be less efficient in these circumstances, the audit is, nevertheless, effective.

.14 The risk of incorrect acceptance and the risk of overreliance on internal accounting control relate to the effectiveness of an audit in detecting an existing material misstatement. These risks are discussed in the following paragraphs.

Sampling in Substantive Tests of Details

Planning Samples

.15 Planning involves developing a strategy for conducting an audit of financial statements. For general guidance on planning, see section 311, *Planning and Supervision*.

.16 When planning a particular sample for a substantive test of details, the auditor should consider

- The relationship of the sample to the relevant audit objective (see section 326, *Evidential Matter*).
- Preliminary estimates of materiality levels.
- The auditor's allowable risk of incorrect acceptance.
- Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

.17 When planning a particular sample, the auditor should consider the specific audit objective to be achieved and should determine that the audit procedure, or combination of procedures, to be applied will achieve that objective. The auditor should determine that the population from which he draws the sample is appropriate for the specific audit objective. For example, an auditor would not be able to detect understatements of an account due to omitted items by sampling the recorded items. An appropriate sampling plan for detecting such understatements would involve selecting from a source in which the omitted items are included. To illustrate, subsequent cash disbursements might be sampled to test recorded accounts payable for understatement because of omitted purchases, or shipping documents might be sampled for understatement of sales due to shipments made but not recorded as sales.

.18 Evaluation in monetary terms of the results of a sample for a substantive test of details contributes directly to the auditor's purpose, since such an evaluation can be related to his judgment of the monetary amount of errors that would be material. When planning a sample for a substantive test of details, the auditor should consider how much monetary error in the related account balance or class of transactions may exist without causing the financial statements to be materially misstated. This maximum monetary error for the balance or class is called *tolerable error* for the sample. Tolerable error is a planning concept and is related to the auditor's preliminary estimates of materiality levels in such a way that tolerable error, combined for the entire audit plan, does not exceed those estimates.

.19 The second standard of field work states, "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted." The second standard of field work recognizes that the extent of substantive tests required to obtain sufficient evidential matter under the third standard should vary inversely with the auditor's reliance on internal accounting control. These standards taken together imply that the combination of the auditor's reliance on internal accounting control and his reliance on his substantive tests should provide a reasonable basis for his opinion, although the portion of reliance derived from the respective sources may vary. The greater the reliance on internal accounting control or on other substantive tests directed toward the same specific audit objective, the greater the allowable risk of incorrect acceptance for the substantive test of details being planned and, thus, the smaller the required sample size for the substantive test of details. For example, if the auditor relies neither on internal accounting control nor on other substantive tests directed toward the same specific audit objective, he should allow for a low risk of incorrect acceptance for the substantive test of details.³ Thus, the

³ Some auditors prefer to think of risk levels in quantitative terms. For example, in the circumstances described, an auditor might think in terms of a 5 percent risk of incorrect acceptance for the substantive test of details. Risk levels used in sampling applications in other

auditor would select a larger sample for the test of details than if he allowed for a higher risk of incorrect acceptance.

.20 The Appendix illustrates how the auditor may relate the risk of incorrect acceptance for a particular substantive test of details to his evaluations of both the internal accounting control system and the effectiveness of any other substantive tests related to the same specific audit objective.

.21 As discussed in section 326, the sufficiency of tests of details for a particular account balance or class of transactions is related to the individual importance of the items examined as well as to the potential for material error. When planning a sample for a substantive test of details, the auditor uses his judgment to determine which items, if any, in an account balance or class of transactions should be individually examined and which items, if any, should be subject to sampling. The auditor should examine those items for which, in his judgment, acceptance of some sampling risk is not justified. For example, these may include items for which potential errors could individually equal or exceed the tolerable error. Any items that the auditor has decided to examine 100 percent are not part of the items subject to sampling. Other items that, in the auditor's judgment, need to be tested to fulfill the audit objective but need not be examined 100 percent, would be subject to sampling.

.22 The auditor may be able to reduce the required sample size by separating items subject to sampling into relatively homogeneous groups on the basis of some characteristic related to the specific audit objective. For example, common bases for such groupings are the recorded or book value of the items, the nature of internal accounting control related to processing the items, and special considerations associated with certain items. An appropriate number of items is then selected from each group.

.23 To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should consider the tolerable error, the allowable risk of incorrect acceptance, and the characteristics of the population. An auditor applies professional judgment to relate these factors in determining the appropriate sample size. The Appendix illustrates the effect these factors may have on sample size.

Sample Selection

.24 Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. For example, random-based selection of items represents one means of obtaining such samples.⁴

Performance and Evaluation

.25 Auditing procedures that are appropriate to the particular audit objective should be applied to each sample item. In some circumstances the auditor may not be able to apply the planned audit procedures to selected sample items because, for example, supporting documentation may be missing. The auditor's treatment of unexamined items will depend on their effect on his evaluation of the sample. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be in error, it is not necessary to examine the items. However, if considering those unexamined

(Footnote Continued)

fields are not necessarily relevant in determining appropriate levels for applications in auditing because an audit includes many interrelated tests and sources of evidence.

⁴ Random-based selection includes, for example, random sampling, stratified random sampling, sampling with probability proportional to size, and systematic sampling (for example, every hundredth item) with one or more random starts.

items to be misstated would lead to a conclusion that the balance or class is materially in error, the auditor should consider alternative procedures that would provide him with sufficient evidence to form a conclusion. The auditor should also consider whether the reasons for his inability to examine the items have implications in relation to his planned reliance on internal accounting control or his degree of reliance on management representations.

.26 The auditor should project the error results of the sample to the items from which the sample was selected.⁵ There are several acceptable ways to project errors from a sample. For example, an auditor may have selected a sample of every twentieth item (50 items) from a population containing one thousand items. If he discovered overstatement errors of \$3,000 in that sample, the auditor could project a \$60,000 overstatement by dividing the amount of error in the sample by the fraction of total items from the population included in the sample. The auditor should add that projection to the errors discovered in any items examined 100 percent. This total projected error should be compared with the tolerable error for the account balance or class of transactions, and appropriate consideration should be given to sampling risk. If the total projected error is less than tolerable error for the account balance or class of transactions, the auditor should consider the risk that such a result might be obtained even though the true monetary error for the population exceeds tolerable error. For example, if the tolerable error in an account balance of \$1 million is \$50,000 and the total projected error based on an appropriate sample (see paragraph .23) is \$10,000, he may be reasonably assured that there is an acceptably low sampling risk that the true monetary error for the population exceeds tolerable error. On the other hand, if the total projected error is close to the tolerable error, the auditor may conclude that there is an unacceptably high risk that the actual errors in the population exceed the tolerable error. An auditor uses professional judgment in making such evaluations.

.27 In addition to the evaluation of the frequency and amounts of monetary misstatements, consideration should be given to the qualitative aspects of the errors. These include (a) the nature and cause of misstatements, such as whether they are differences in principle or in application, are errors or irregularities, or are due to misunderstanding of instructions or to carelessness, and (b) the possible relationship of the misstatements to other phases of the audit. The discovery of an irregularity ordinarily requires a broader consideration of possible implications than does the discovery of an error.

.28 If the sample results suggest that the auditor's planning assumptions were in error, he should take appropriate action. For example, if monetary errors are discovered in a substantive test of details in amounts or frequency that is greater than is consistent with the degree of reliance initially placed on internal accounting control, the auditor should alter his preliminary evaluation of the internal accounting control system. The auditor should also consider whether to modify the audit tests of other accounts that were designed with reliance placed on those internal accounting controls. For example, a large number of errors discovered in confirmation of receivables may indicate the need to reconsider the initial evaluation of the reliance to be placed on internal accounting control for purposes of designing substantive tests of sales or cash receipts.

⁵ If the auditor has separated the items subject to sampling into relatively homogeneous groups (see paragraph .22), he separately projects the error results of each group and sums them.

.29 The auditor should relate the evaluation of the sample to other relevant audit evidence when forming a conclusion about the related account balance or class of transactions.

.30 Projected error results for all audit sampling applications and all known errors from nonsampling applications should be considered in the aggregate along with other relevant audit evidence when the auditor evaluates whether the financial statements taken as a whole may be materially misstated.

Sampling in Compliance Tests of Internal Accounting Controls

Planning Samples

.31 When planning a particular audit sample for a compliance test of details, the auditor should consider

- The relationship of the sample to the objective of the compliance test.
- The maximum rate of deviations from prescribed control procedures that would support his planned reliance.
- The auditor's allowable risk of overreliance.
- Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

.32 Sampling generally is not applicable to tests of compliance with internal accounting control procedures that depend primarily on appropriate segregation of duties or that otherwise provide no documentary evidence of performance (see section 320.67 in Appendix G). When designing samples for the purpose of testing compliance with internal accounting control procedures that leave an audit trail of documentary evidence, the auditor ordinarily should plan to evaluate compliance in terms of deviations from (or compliance with) pertinent control procedures, as to either the rate of such deviations or the monetary amount of the related transactions.⁶ In this context, pertinent control procedures are ones that, had they not been included in the design of the internal accounting control system, would have adversely affected the auditor's preliminary evaluation of the system. The auditor's overall evaluation of controls for a particular purpose involves combining judgments about the prescribed controls, the sample results of compliance tests, and the results of observation and inquiry about controls not leaving an audit trail of documentary evidence. [Reference changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

.33 The auditor should assess the maximum rate of deviations from a prescribed control procedure that he would be willing to accept without altering his planned reliance on the control. This is the *tolerable rate*. In assessing the tolerable rate, the auditor should consider the relationship of procedural deviations to (a) the accounting records being tested, (b) any related internal accounting control procedures, and (c) the purpose of the auditor's evaluation. For example, if substantial reliance is to be placed on the control procedures, he may decide that a tolerable rate of 5 percent or possibly less would be reasonable; if less reliance is planned, the auditor may decide that a tolerable rate of 10 percent is reasonable.

⁶ For simplicity the remainder of this section will refer to only the rate of deviations.

.34 In assessing the tolerable rate of deviations, the auditor should consider that, while deviations from pertinent control procedures increase the risk of material errors in the accounting records, such deviations do not necessarily result in errors. For example, a recorded disbursement that does not show evidence of required approval may nevertheless be a transaction that is properly authorized and recorded. Deviations would result in errors in the accounting records only if the deviations and the errors occurred on the same transactions. Deviations from pertinent control procedures at a given rate ordinarily would be expected to result in errors at a lower rate.

.35 In some situations, an internal accounting control objective may be achieved by a combination of procedures. If a combination of two or more control procedures is necessary to achieve an internal accounting control objective, those control procedures should be regarded as a single procedure, and deviations from any procedure in the combination should be evaluated on that basis. If both control procedures are designed to achieve the objective individually, the significance of compliance deviations from a control procedure on which the auditor intends to rely is affected by the potential effectiveness of the related control procedure.

.36 Samples taken for compliance tests are intended to provide a basis for the auditor to conclude whether internal accounting control procedures are being applied as prescribed. Because the compliance test is the primary source of evidence of whether the procedure is being applied as prescribed, the auditor should allow for a low level of risk of overreliance.⁷

.37 To determine the number of items to be selected for a particular sample for a compliance test, the auditor should consider the tolerable rate of deviation from the control(s) being tested, based on the planned degree of reliance; the likely rate of deviations; and the allowable risk of overreliance on internal accounting controls. An auditor applies professional judgment to relate these factors in determining the appropriate sample size.

Sample Selection

.38 Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. Random-based selection of items represents one means of obtaining such samples. Ideally, the auditor should use a selection method that has the potential for selecting items from the entire period under audit. Section 320.70 (see Appendix G) provides guidance applicable to the auditor's use of sampling during interim and remaining periods. [Reference changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

Performance and Evaluation

.39 Auditing procedures that are appropriate to achieve the objective of the compliance test should be applied to each sample item. If the auditor is not able to apply the planned audit procedures or appropriate alternative procedures to selected items, he should consider the reasons for this limitation, and he should ordinarily consider those selected items to be deviations from the procedures for the purpose of evaluating the sample.

.40 The deviation rate in the sample is the auditor's best estimate of the deviation rate in the population from which it was selected. If the estimated

⁷ The auditor who prefers to think of risk levels in quantitative terms might consider, for example, a 5 percent to 10 percent risk of overreliance on internal accounting control.

deviation rate is less than the tolerable rate for the population, the auditor should consider the risk that such a result might be obtained even though the true deviation rate for the population exceeds the tolerable rate for the population. For example, if the tolerable rate for a population is 5 percent and no deviations are found in a sample of 60 items, the auditor may conclude that there is an acceptably low sampling risk that the true deviation rate in the population exceeds the tolerable rate of 5 percent. On the other hand, if the sample includes, for example, two or more deviations, the auditor may conclude that there is an unacceptably high sampling risk that the rate of deviations in the population exceeds the tolerable rate of 5 percent. An auditor applies professional judgment in making such an evaluation.

.41 In addition to the evaluation of the frequency of deviations from pertinent procedures, consideration should be given to the qualitative aspects of the deviations. These include (a) the nature and cause of the deviations, such as whether they are errors or irregularities or are due to misunderstanding of instructions or to carelessness, and (b) the possible relationship of the deviations to other phases of the audit. The discovery of an irregularity ordinarily requires a broader consideration of possible implications than does the discovery of an error.

.42 If the auditor concludes that the sample results do not support the planned degree of reliance on the control procedure, planned substantive tests should be altered.

Dual-Purpose Samples

.43 In some circumstances the auditor may design a sample that will be used for dual purposes: testing compliance with a control procedure that provides documentary evidence of performance and testing whether the recorded monetary amount of transactions is correct. In general, an auditor planning to use a dual-purpose sample would have made a preliminary assessment that there is an acceptably low risk that the rate of compliance deviations in the population exceeds the tolerable rate. For example, an auditor designing a compliance test of a control procedure over entries in the voucher register may plan a related substantive test at a risk level that anticipates reliance on that internal accounting control. The size of a sample designed for dual purposes should be the larger of the samples that would otherwise have been designed for the two separate purposes. In evaluating such tests, deviations from pertinent procedures and monetary errors should be evaluated separately using the risk levels applicable for the respective purposes.

Selecting a Sampling Approach

.44 As discussed in paragraph .04, either a nonstatistical or statistical approach to audit sampling, when properly applied, can provide sufficient evidential matter.

.45 Statistical sampling helps the auditor (a) to design an efficient sample,⁸ (b) to measure the sufficiency of the evidential matter obtained, and

⁸ SAS No. 1, sections 320A and 320B, which are superseded by this section, used the terms *reliability* and *precision* to discuss the design of statistical audit samples. This section uses the word *risk* instead of *reliability* (*risk* is the complement of *reliability*) and the concepts of *tolerable error* and an *allowance for sampling risk* instead of *precision*. There are two reasons for this change: First, this section applies to both statistical and nonstatistical sampling and therefore requires nontechnical terms, and second, the words *reliability* and *precision* each have been used to mean different things. Auditors may, of course, use whatever terms they prefer as long as they understand the relationship of those terms to the concepts in this section.

(c) to evaluate the sample results. By using statistical theory, the auditor can quantify sampling risk to assist himself in limiting it to a level he considers acceptable. However, statistical sampling involves additional costs of training auditors, designing individual samples to meet the statistical requirements, and selecting the items to be examined. Because either nonstatistical or statistical sampling can provide sufficient evidential matter, the auditor chooses between them after considering their relative cost and effectiveness in the circumstances.

Effective Date

.46 This section is effective for examinations of financial statements for periods ended on or after June 25, 1983. Earlier application is encouraged. [As amended, effective retroactively to June 25, 1982, by Statement on Auditing Standards No. 43.]

.47 Appendix

Relating the Risk of Incorrect Acceptance for a Substantive Test of Details to Other Sources of Audit Reliance

1. Audit risk, with respect to a particular account balance or class of transactions, is the risk that there is a monetary error greater than tolerable error in the balance or class that the auditor fails to detect. The auditor uses professional judgment in determining the allowable audit risk for a particular examination after he considers such factors as the risk of material misstatement in the financial statements, the cost to reduce the risk, and the effect of the potential misstatement on the use and understanding of the financial statements.

2. An auditor relies on the internal accounting controls, analytical review procedures, and substantive tests of details in whatever combination he believes adequately controls audit risk. However, the second standard of field work does not contemplate that the auditor will place complete reliance on internal accounting control to the exclusion of other auditing procedures with respect to material amounts in the financial statements.

3. The sufficiency of audit sample sizes, whether nonstatistical or statistical, is influenced by several factors. Table 1 illustrates how several of these factors may affect sample sizes for a substantive test of details. Factors *a* and *b* in table 1 should be considered together (see paragraph .08). For example, weak internal accounting controls and the absence of other substantive tests related to the same audit objective ordinarily require larger sample sizes for related substantive tests of details than if there were other sources of reliance. Alternatively, strong internal accounting controls in combination with highly effective analytical review procedures and other relevant substantive tests may lead the auditor to conclude that the sample, if any, needed for an additional test of details can be small.

4. The following model expresses the general relationship of the risks associated with the auditor's evaluation of internal accounting controls, substantive tests of details, and analytical review procedures and other relevant substantive tests. The model is not intended to be a mathematical formula including all factors that may influence the determination of individual risk components; however, some auditors find such a model to be useful when planning appropriate risk levels for audit procedures to achieve the auditor's desired audit risk.

$$UR = IC \times AR \times TD$$

An auditor might use this model to obtain an understanding of an appropriate risk of incorrect acceptance for a substantive test of details as follows:

$$TD = UR / (IC \times AR)$$

UR = The allowable audit risk that monetary errors equal to tolerable error might remain undetected in the account balance or class of transactions after the auditor has completed all audit procedures deemed necessary.¹ The auditor uses his professional judgment to determine the allowable audit risk after considering factors such as those discussed in paragraph 1 of this Appendix.

¹ For purposes of this Appendix, the nonsampling risk aspect of audit risk is assumed to be negligible, based on the level of quality controls in effect. [Footnote amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

IC = The auditor's assessment of the risk that, given that errors equal to tolerable error occur, the system of internal accounting control fails to detect them, whether because of poorly designed controls or lack of compliance. The auditor would assign this risk for control procedures on which he intends to rely in establishing the scope of the substantive test of details.² The quantification for this model relates to the auditor's evaluation of the overall effectiveness of those internal accounting controls that would prevent or detect material errors equal to tolerable error in the related account balance or class of transactions. For example, if the auditor believes that pertinent controls would prevent or detect errors equal to tolerable error about half the time, he would assess this risk as 50 percent. (IC is not the same as the risk of overreliance on internal accounting control.)

AR = The auditor's assessment of the risk that analytical review procedures and other relevant substantive tests would fail to detect errors equal to tolerable error, given that such errors occur and are not detected by the system of internal accounting control.

TD = The allowable risk of incorrect acceptance for the substantive test of details, given that errors equal to tolerable error occur and are not detected by the system of internal accounting control or analytical review procedures and other relevant substantive tests.

5. The auditor planning a statistical sample can use the relationship in paragraph 4 of this Appendix to assist in planning his allowable risk of incorrect acceptance for a specific substantive test of details. To do so, he selects an acceptable audit risk (UR) and subjectively quantifies his judgment of risks IC and AR. Some levels of these risks are implicit in evaluating audit evidence and reaching conclusions. Auditors using the relationship prefer to evaluate these judgment risks explicitly.

6. The relationships between these independent risks are illustrated in table 2. In table 2 it is assumed, for illustrative purposes, that the auditor has chosen an audit risk of 5 percent. Table 2 incorporates the premise that no system of internal accounting control can be expected to be completely effective in detecting aggregate errors equal to tolerable error that might occur (see section 320.35 in Appendix G). The table also illustrates the fact that the risk level for substantive tests of particular account balances or classes of transactions is not an isolated decision. Rather, it is a direct consequence of the auditor's evaluation of reliance on internal accounting control and analytical review procedures and other relevant substantive tests, and it cannot be properly considered out of this context. [As amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.) [Reference number 320.35, formerly 320.34, changed by the issuance of Statement on Auditing Standards No. 48.]

² The risk that monetary errors equal to tolerable error would have occurred in the absence of internal accounting controls related to the account balance or class of transactions under audit is difficult and potentially costly to quantify. For this reason in this model it is implicitly set conservatively at one, although audit experience indicates clearly that it is substantially lower. Accordingly, it is not a factor in the relationship expressed above. Therefore, the actual risk will ordinarily be less than UR.

Table 1

**Factors Influencing Sample Sizes for a
Substantive Test of Details in Sample Planning**

<i>Factor</i>	<i>Conditions leading to</i>		<i>Related factor for substantive sample planning</i>
	<i>Smaller sample size</i>	<i>Larger sample size</i>	
a. Reliance on internal accounting controls.	Greater reliance on internal accounting controls.	Lesser reliance on internal accounting controls.	Allowable risk of incorrect acceptance.
b. Reliance on other substantive tests related to same account balance or class of transactions (including analytical review procedures and other relevant substantive tests).	Substantial reliance to be placed on other relevant substantive tests.	Little or no reliance to be placed on other relevant substantive tests.	Allowable risk of incorrect acceptance.
c. Measure of tolerable error for a specific account.	Larger measure of tolerable error.	Smaller measure of tolerable error.	Tolerable error.
d. Expected size and frequency of errors.	Smaller errors or lower frequency.	Larger errors or higher frequency.	Assessment of population characteristics.
e. Number of items in population.	Virtually no effect on sample size unless population is very small.		

Table 2

**Allowable Risk of Incorrect Acceptance (TD)
for Various Assessments of IC and AR for UR = .05**

Auditor's subjective assessment of risk that internal accounting control might fail to detect aggregate errors equal to tolerable error.

Auditor's subjective assessment of risk that analytical review procedures and other relevant substantive tests might fail to detect aggregate errors equal to tolerable error.

<i>IC</i>	<i>AR</i>			
	<i>10%</i>	<i>30%</i>	<i>50%</i>	<i>100%</i>
	<i>TD</i>			
10%	*	*	*	50%
30%	*	55%	33%	16%
50%	*	33%	20%	10%
100%	50%	16%	10%	5%

* The allowable level of UR of 5 percent exceeds the product of IC and AR, and, thus, the planned substantive test of details may not be necessary.

NOTE: Table entries for TD are computed from the illustrative model: $TD = UR / (IC \times AR)$. For example, for $IC = .50$ and $AR = .30$, $TD = .05 / (.50 \times .30)$ or .33 (equals 33%).

AU Section 380

Communication With Audit Committees

Source: SAS No. 61.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section establishes a requirement for the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process.¹ For purposes of this document, the recipient of the communications is referred to as the *audit committee*. The communications required by this section are applicable to (1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee) and (2) all Securities and Exchange Commission (SEC) engagements.²

.02 This section requires the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit

¹ Communication with the audit committee by the independent auditor on certain specified matters when they arise in the conduct of an audit is required by other standards, including—

- Section 325, *Communication of Internal Control Structure Related Matters Noted in an Audit*.
- Section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*.
- Section 317, *Illegal Acts By Clients*.
- Section 722, *Review of Interim Financial Information*.

This section does not modify the requirements of these standards.

² For purposes of this section, an SEC engagement is defined as one that involves the audit of the financial statements of—

1. An issuer making an initial filing, including amendments, under the Securities Act of 1933 and the Securities Exchange Act of 1934.
2. A registrant that files periodic reports with the SEC under the Investment Company Act of 1940 or the Securities Exchange Act of 1934 (except a broker or dealer registered only because of section 15(a) of the 1934 Act).
3. A bank or other lending institution that files periodic reports with the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, or the Federal Home Loan Bank Board because the powers, functions, and duties of the SEC to enforce its periodic reporting provisions are vested, pursuant to section 12(i) of the 1934 Act, in those agencies. (Section 12(g) of the Securities Exchange Act of 1934 provides an exemption from periodic reporting to the SEC to [1] entities with less than \$5 million in total assets on the last day of each of the entity's three most recent fiscal years and fewer than 500 shareholders and [2] entities with fewer than 300 shareholders. Accordingly, such entities are not encompassed within the scope of this definition.)
4. A company whose financial statements appear in the annual report or proxy statement of any investment fund because it is a sponsor or manager of such a fund, but which is not itself a registrant required to file periodic reports under the 1940 Act or section 13 or 15(d) of the Securities Exchange Act of 1934.

that may assist the audit committee in overseeing the financial reporting and disclosure process for which management is responsible. This section does not require communications with management; however, it does not *preclude* communications with management or other individuals within the entity who may, in the auditor's judgment, benefit from the communications.

.03 The communications may be oral or written. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers. When the auditor communicates in writing, the report should indicate that it is intended solely for the use of the audit committee or the board of directors and, if appropriate, management.

.04 The communications specified by this section are incidental to the audit. Accordingly, they are not required to occur before the issuance of the auditor's report on the entity's financial statements so long as the communications occur on a timely basis. There may be occasions, however, when discussion of certain of the matters (specified by paragraphs .06 through .14 below) with the audit committee prior to the issuance of the report may, in the auditor's judgment, be desirable.

.05 It may be appropriate for management to communicate to the audit committee certain of the matters specified in this section. In such circumstances, the auditor should be satisfied that such communications have, in fact, occurred. Generally, it is not necessary to repeat the communication of recurring matters each year. Periodically, however, the auditor should consider whether, because of changes in the audit committee or simply because of the passage of time, it is appropriate and timely to report such matters. Finally, this section is not intended to restrict the communication of other matters.

Matters to Be Communicated

The Auditor's Responsibility Under Generally Accepted Auditing Standards

.06 An audit performed in accordance with generally accepted auditing standards may address many matters of interest to an audit committee. For example, an audit committee is usually interested in the internal control structure and in whether the financial statements are free of material misstatement. In order for the audit committee to understand the nature of the assurance provided by an audit, the auditor should communicate the level of responsibility assumed for these matters under generally accepted auditing standards. It is also important for the audit committee to understand that an audit conducted in accordance with generally accepted auditing standards is designed to obtain reasonable, rather than absolute, assurance about the financial statements.

Significant Accounting Policies

.07 The auditor should determine that the audit committee is informed about the initial selection of and changes in significant accounting policies or their application. The auditor should also determine that the audit committee is informed about the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. For example, significant accounting issues may exist in areas such as revenue recognition, off-balance-sheet financing, and accounting for equity investments.

Management Judgments and Accounting Estimates

.08 Accounting estimates are an integral part of the financial statements prepared by management and are based upon management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Significant Audit Adjustments

.09 The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements that, in the auditor's judgment, may not have been detected except through the auditing procedures performed. Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements.

Other Information in Documents Containing Audited Financial Statements

.10 The audit committee often considers information prepared by management that accompanies the entity's financial statements. An example of information of this nature would be the "Management's Discussion and Analysis of Financial Condition and Results of Operations" that certain entities that file reports with the SEC are required to present in annual reports to shareholders. Section 550, *Other Information in Documents Containing Audited Financial Statements*, establishes the auditor's responsibility for such information.³ The auditor should discuss with the audit committee his responsibility for other information in documents containing audited financial statements, any procedures performed, and the results.

Disagreements With Management

.11 Disagreements with management may occasionally arise over the application of accounting principles to the entity's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements may also arise regarding the scope of the audit, disclosures to be included in the entity's financial statements, and the wording of the auditor's report. The auditor should discuss with the audit committee any disagreements with management,⁴ whether or not satisfactorily resolved,

³ Guidance on the auditor's consideration of other information is also provided by section 558, *Required Supplementary Information*; section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and section 711, *Filings Under Federal Securities Statutes*.

⁴ The glossary to Financial Accounting Standards Board (FASB) Statement No. 57, *Related Party Disclosures* [AC section R36], defines management as follows:

Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief

about matters that individually or in the aggregate could be significant to the entity's financial statements or the auditor's report. For purposes of this section, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.

Consultation With Other Accountants

.12 In some cases, management may decide to consult with other accountants about auditing and accounting matters. When the auditor is aware that such consultation has occurred, he should discuss with the audit committee his views about significant matters that were the subject of such consultation.⁵

Major Issues Discussed With Management Prior to Retention

.13 The auditor should discuss with the audit committee any major issues that were discussed with management in connection with the initial or recurring retention of the auditor including, among other matters, any discussions regarding the application of accounting principles and auditing standards.

Difficulties Encountered in Performing the Audit

.14 The auditor should inform the audit committee of any serious difficulties he encountered in dealing with management related to the performance of the audit. This may include, among other things, unreasonable delays by management in permitting the commencement of the audit or in providing needed information, and whether the timetable set by management was unreasonable under the circumstances. Other matters that the auditor may encounter include the unavailability of client personnel and the failure of client personnel to complete client-prepared schedules on a timely basis. If the auditor considers these matters significant, he should inform the audit committee.

Effective Date

.15 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

(Footnote Continued)

executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy-making functions. Persons without formal titles also may be members of management.

⁵ Circumstances in which the auditor should be informed of such consultations are described in section 625, *Reports on the Application of Accounting Principles*, paragraph .07.

AU Section 390***Consideration of Omitted
Procedures After the
Report Date***

Source: SAS No. 46.

Effective, unless otherwise indicated: October 31, 1983.

.01 This section provides guidance on the considerations and procedures to be applied by an auditor who, subsequent to the date of his report on audited financial statements, concludes that one or more auditing procedures considered necessary at the time of the examination in the circumstances then existing were omitted from his examination of the financial statements, but there is no indication that those financial statements are not fairly presented in conformity with generally accepted accounting principles or with another comprehensive basis of accounting.¹ This circumstance should be distinguished from that described in section 561, which applies if an auditor, subsequent to the date of his report on audited financial statements, becomes aware that facts regarding those financial statements may have existed at that date that might have affected his report had he then been aware of them.

.02 Once he has reported on audited financial statements, an auditor has no responsibility to carry out any retrospective review of his work. However, reports and working papers relating to particular engagements may be subjected to postissuance review in connection with a firm's internal inspection program,² peer review, or otherwise, and the omission of a necessary auditing procedure may be disclosed.

.03 A variety of conditions might be encountered in which an auditing procedure considered necessary at the time of the examination in the circumstances then existing has been omitted; therefore, the considerations and procedures described herein necessarily are set forth only in general terms. The period of time during which the auditor considers whether this section applies to the circumstances of a particular engagement and then takes the actions, if any, that are required hereunder may be important. Because of legal implications that may be involved in taking the actions contemplated herein, the auditor would be well advised to consult with his attorney when he encounters the circumstances to which this section may apply, and, with the attorney's advice and assistance, determine an appropriate course of action.

.04 When the auditor concludes that an auditing procedure considered necessary at the time of the examination in the circumstances then existing

¹ The provisions of this section are not intended to apply to an engagement in which an auditor's work is at issue in a threatened or pending legal proceeding or regulatory investigation. (A *threatened legal proceeding* means that a potential claimant has manifested to the auditor an awareness of, and present intention to assert, a possible claim.)

² See section 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*, paragraph .02, and related quality control standards regarding the quality control function of inspection.

was omitted from his examination of financial statements, he should assess the importance of the omitted procedure to his present ability to support his previously expressed opinion regarding those financial statements taken as a whole. A review of his working papers, discussion of the circumstances with engagement personnel and others, and a reevaluation of the overall scope of his examination may be helpful in making this assessment. For example, the results of other procedures that were applied may tend to compensate for the one omitted or make its omission less important. Also, subsequent examinations may provide audit evidence in support of the previously expressed opinion.

.05 If the auditor concludes that the omission of a procedure considered necessary at the time of the examination in the circumstances then existing impairs his present ability to support his previously expressed opinion regarding the financial statements taken as a whole, and he believes there are persons currently relying, or likely to rely, on his report, he should promptly undertake to apply the omitted procedure or alternative procedures that would provide a satisfactory basis for his opinion.

.06 When as a result of the subsequent application of the omitted procedure or alternative procedures, the auditor becomes aware that facts regarding the financial statements existed at the date of his report that would have affected that report had he been aware of them, he should be guided by the provisions of section 561.05—.09.

.07 If in the circumstances described in paragraph .05, the auditor is unable to apply the previously omitted procedure or alternative procedures, he should consult his attorney to determine an appropriate course of action concerning his responsibilities to his client, regulatory authorities, if any, having jurisdiction over the client, and persons relying, or likely to rely, on his report.

Effective Date

.08 This section is effective as of October 31, 1983.

AU Section 400

THE FIRST, SECOND, AND THIRD STANDARDS OF REPORTING

... adherence to principles ... meaning of
present fairly ... consistency ... adequacy of
disclosure ... segment information ...

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➡ The next page is 481. ⬅

AU Section 410***Adherence to Generally Accepted Accounting Principles***

Sources: SAS No. 1, section 410; SAS No. 14.

See section 9410 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 The first standard of reporting is:

The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

.02 The term "generally accepted accounting principles" as used in reporting standards is construed to include not only accounting principles and practices but also the methods of applying them. The first reporting standard is construed not to require a statement of fact by the auditor but an opinion as to whether the financial statements are presented in conformity with such principles.¹ If limitations on the scope of the auditor's examination make it impossible for him to form an opinion as to such conformity, appropriate qualification of his report is required. [Amended by Statement on Auditing Standards No. 14, effective with respect to engagements to issue special reports on data for periods beginning after December 31, 1976.] (See section 621.)

[.03—.04] [Superseded July 1975 by Statement on Auditing Standards No. 5.] (See section 411.)

[The next page is 485.]

¹ When an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the first standard of reporting is satisfied by disclosing in the auditor's report that the statements are not intended to conform with generally accepted accounting principles and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used (see section 621.02—.08, *Special Reports*).

AU Section 411

The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report

(Supersedes section 410.03—.04 ¹)

Sources: SAS No. 5; SAS No. 43.

Issue date, unless otherwise indicated: July, 1975.

.01 An independent auditor's unqualified opinion usually reads as follows:

In our opinion, the financial statements referred to above present fairly the financial position of X Company as of (at) December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

The purpose of this section is to explain the meaning of the phrase "present fairly . . . in conformity with the generally accepted accounting principles" in the independent auditor's report.²

.02 The first standard of reporting requires an auditor who has examined financial statements in accordance with generally accepted auditing standards to state in his report whether the statements are presented in accordance with generally accepted accounting principles. The phrase "generally accepted accounting principles" is a technical accounting term which encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures (see paragraph 138 of Statement No. 4 of the Accounting Principles Board). Those conventions, rules, and procedures provide a standard by which to measure financial presentations.

.03 The independent auditor's judgment concerning the "fairness" of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles. Without that framework the auditor would have no uniform standard for judging the presentation

¹ This section amends the text of section 210.05 by deletion of the last sentence to that section.

² This section clarifies and explains matters relating to the form of auditor's report presently in use; the section is not a result of a reconsideration of the form itself.

of financial position, results of operations, and changes in financial position in financial statements.

.04 The auditor's opinion that financial statements present fairly an entity's financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles should be based on his judgment as to whether (a) the accounting principles selected and applied have general acceptance (see paragraphs .05 and .06); (b) the accounting principles are appropriate in the circumstances (see paragraphs .07-.09); (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation (see section 431); (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed (see section 431); and (e) the financial statements reflect the underlying events and transactions in a manner that presents the financial position, results of operations, and changes in financial position stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.³ [References changed by issuance of Statement on Auditing Standards No. 32.]

.05 Independent auditors agree on the existence of a body of generally accepted accounting principles, and they are experts in those accounting principles and in the determination of their general acceptance. Nevertheless, the determination that a particular accounting principle is generally accepted may be difficult because no single reference source exists for all such principles. The sources of established accounting principles are generally the following:

- a. Accounting principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to rule 203 [ET section 203.01] of the AICPA Code of Professional Conduct
- b. Pronouncements of bodies composed of expert accountants that follow a due process procedure, including broad distribution of proposed accounting principles for public comment, for the intended purpose of establishing accounting principles or describing existing practices that are generally accepted
- c. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry or the knowledgeable application to specific circumstances of pronouncements that are generally accepted
- d. Other accounting literature

[As amended, April 1988, by Statement on Auditing Standards No. 52.]

.06 Category (a), officially established accounting principles, includes Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards, FASB Interpretations, Accounting Principles Board (APB) Opinions, AICPA Accounting Research Bulletins and, for financial statements of state and local governmental entities, statements and interpretations of the Governmental Accounting Standards Board (GASB).⁴ If, for a state or local governmental entity, the accounting treatment of a transaction

³ The concept of materiality is inherent in the auditor's judgments. That concept involves qualitative as well as quantitative judgments (see section 150.04 and section 509.16 in Appendix G).

⁴ Some of these pronouncements have been superseded or amended by other pronouncements of both the APB and the FASB, and, in the future, they may be superseded or amended by pronouncements of an authoritative body pursuant to rule 203 (ET section 203.01).

or event is not specified by a pronouncement of the GASB, applicable pronouncements of the FASB are presumed to apply. Rule 203 (ET section 203.01) provides that an auditor should not express an unqualified opinion if the financial statements contain a material departure from such pronouncements unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. Rule 203 (ET section 203.01) implies that application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows, in conformity with generally accepted accounting principles. Interpretation 203-1 (ET section 203.02) of the AICPA Code of Professional Conduct states, "There is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading." Nevertheless, rule 203 (ET section 203.01) provides for the possibility that literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements. When the unusual circumstances contemplated by rule 203 (ET section 203.01) exist and the statements depart from a pronouncement, the auditor's report should present, in a separate paragraph or paragraphs, the information required by rule 203 (ET section 203.01), including a description of the departure, its approximate effects (if practicable), and the reasons why the departure is necessary to prevent the financial statements from being misleading. In those circumstances, however, unless there are reasons other than the departure to modify his opinion, the auditor should express an unqualified opinion on conformity with generally accepted accounting principles. [As amended, April 1988, by Statement on Auditing Standards No. 52.]

.07 If the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 (ET section 203.01), the auditor should consider whether the accounting treatment is specified by another source of established accounting principles. Categories (b) and (c) are both sources of established accounting principles. Category (b) includes AICPA Industry Audit and Accounting Guides, AICPA Statements of Position, and Technical Bulletins issued by the FASB or GASB; category (c) includes AICPA Accounting Interpretations, as well as practices that are widely recognized and prevalent in the industry. If an established accounting principle from one or more sources in category (b) or (c) is relevant to the circumstances, the auditor should be prepared to justify a conclusion that another treatment is generally accepted. If there is a conflict between sources within those categories, the auditor should consider which treatment better presents the substance of the transaction in the circumstances. [As amended, April 1988, by Statement on Auditing Standards No. 52.]

.08 In the absence of a pronouncement covered by rule 203 (ET section 203.01) or another source of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances.⁵ Other accounting literature includes, for example, APB Statements, AICPA Issues Papers, AcSEC Practice Bulletins, minutes of the FASB Emerging Issues Task Force, FASB Statements of Financial Accounting Concepts, Concepts Statements of the GASB, International Accounting Standards Committee Statements of International Accounting Standards, pronouncements of other professional associations or regulatory agencies, and accounting

⁵ The auditor should be aware that the accounting requirements adopted by regulatory agencies for reports filed with them may differ from generally accepted accounting principles in certain respects. Section 544, *Lack of Conformity With Generally Accepted Accounting Principles*, paragraph .04, and section 621, *Special Reports*, provide guidance if the auditor is reporting on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.

textbooks and articles. The appropriateness of other accounting literature as a source of established accounting principles depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, FASB Statements of Financial Accounting Concepts would normally be more influential than accounting textbooks or articles. [As amended, April 1988, by Statement on Auditing Standards No. 52.]

.09 Generally accepted accounting principles recognize the importance of recording transactions in accordance with their substance.⁶ The auditor should consider whether the substance of transactions differs materially from their form. [Formerly paragraph .07, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.10 The auditor should be familiar with alternative accounting principles that may be applicable to the transaction or facts under consideration and realize that an accounting principle may have only limited usage but still have general acceptance. On occasion, established accounting principles may not exist for recording and presenting a specific event or transaction because of developments such as new legislation or the evolution of a new type of business transaction. In certain instances, it may be possible to account for the event or transaction on the basis of its substance by selecting an accounting principle that appears appropriate when applied in a manner similar to the application of an established principle to an analogous event or transaction. [Formerly paragraph .08, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.11 Specifying the circumstances in which one accounting principle should be selected from among alternative principles is the function of bodies having authority to establish accounting principles. When criteria for selection among alternative accounting principles have not been established to relate accounting methods to circumstances, the auditor may conclude that more than one accounting principle is appropriate in the circumstances.⁷ The auditor should recognize, however, that there may be unusual circumstances in which the selection and application of specific accounting principles from among alternative principles may make the financial statements taken as a whole misleading. [Formerly paragraph .09, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

[The next page is 491.]

⁶ See section 110.02, for an explanation of the distinction between the responsibilities of an auditor and the client's management. [Formerly footnote 4, changed by issuance of Statement on Auditing Standards No. 43.]

⁷ For example, at the time of issuance of this section, established accounting principles do not include criteria for relating the choice among some alternative methods, such as inventory methods or depreciation methods, to the circumstances of a particular company. [Formerly footnote 5 changed by the issuance of Statement on Auditing Standards No. 43.]

AU Section 420***Consistency of Application
of Generally Accepted
Accounting Principles***

Sources: SAS No. 1, section 420; SAS No. 43.

See section 9420 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 The second standard of reporting (referred to herein as the consistency standard) is:

The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

.02 The objective of the consistency standard is (a) to give assurance that the comparability of financial statements between periods has not been materially affected by changes in accounting principles, which include not only accounting principles and practices but also the methods of applying them, or (b) if comparability has been materially affected by such changes, to require appropriate reporting by the independent auditor regarding such changes. It is implicit in the objective that such principles have been consistently observed within each period.

.03 Proper application of the consistency standard by the independent auditor requires an understanding of the relationship of consistency to comparability. Although lack of consistency may cause lack of comparability, other factors unrelated to consistency may also cause lack of comparability.¹

.04 A comparison of the financial statements of an entity between years may be affected by (a) accounting changes, (b) an error in previously issued financial statements, (c) changes in classification, and (d) events or transactions substantially different from those accounted for in previously issued statements. Accounting change, as defined in APB Opinion No. 20 [AC section A06], means a change in (1) an accounting principle, (2) an accounting estimate, or (3) the reporting entity (which is a special type of change in accounting principle).

.05 Changes in accounting principle having a material effect on the financial statements require recognition in the independent auditor's opinion as to consistency. Other factors affecting comparability in financial statements may require disclosure, but they would not ordinarily be commented upon in the independent auditor's report.

¹ For a discussion of comparability of financial statements of a single enterprise, see paragraphs 95 through 97 of Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises".

Accounting Changes Affecting Consistency

Change in Accounting Principle

.06 "A change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term *accounting principle* includes not only accounting principles and practices but also the methods of applying them."² A change in accounting principle includes, for example, a change from the straight-line method to the declining balance method of depreciation for all assets in a class or for all newly acquired assets in a class. The consistency standard is applicable to this type of change and requires recognition in the auditor's opinion as to consistency. [As modified, effective January 1, 1975, by FASB Statement No. 2 (AC section R50).]

Change in the Reporting Entity

.07 Since a change in the reporting entity is a special type of change in accounting principle, the consistency standard is applicable. Changes in reporting entity that require recognition in the auditor's opinion include:

- a. Presenting consolidated or combined statements in place of statements of individual companies.
- b. Changing specific subsidiaries comprising the group of companies for which consolidated statements are presented.
- c. Changing the companies included in combined financial statements.
- d. Changing among the cost, equity, and consolidation methods of accounting for subsidiaries or other investments in common stock.

.08 A business combination accounted for by the pooling-of-interests method also results in a change in reporting entity. The application of the consistency standard to this type of change is discussed in section 546.12—.13 (see Appendix G).

.09 For purposes of application of the consistency standard, a change in reporting entity does not result from the creation, cessation, purchase, or disposition of a subsidiary or other business unit.

Correction of an Error in Principle

.10 A change from an accounting principle that is not generally accepted to one that is generally accepted, including correction of a mistake in the application of a principle, is a correction of an error. Although this type of change in accounting principle should be accounted for as the correction of an error,³ the change requires recognition in the auditor's opinion as to consistency.⁴

² Accounting Principles Board Opinion No. 20, paragraph 7 [AC section A06.105].

³ See paragraphs 13, 36, and 37 of Accounting Principles Board Opinion No. 20 [AC section A35.104—.105].

⁴ The appropriate form of reporting on consistency in such circumstances is similar to that illustrated in section 546.02 (see Appendix G).

Change in Principle Inseparable From Change in Estimate

.11 The effect of a change in accounting principle may be inseparable from the effect of a change in estimate.⁵ Although the accounting for such a change is the same as that accorded a change only in estimate, a change in principle is involved. Accordingly, this type of change requires recognition in the independent auditor's opinion as to consistency.

Changes Not Affecting Consistency

Change in Accounting Estimate

.12 Accounting estimates (such as service lives and salvage values of depreciable assets and provisions for warranty costs, uncollectible receivables, and inventory obsolescence) are necessary in the preparation of financial statements. Accounting estimates change as new events occur and as additional experience and information are acquired. This type of accounting change is required by altered conditions that affect comparability but do not involve the consistency standard. The independent auditor, in addition to satisfying himself with respect to the conditions giving rise to the change in accounting estimate, should satisfy himself that the change does not include the effect of a change in accounting principle. Provided he is so satisfied, he need not comment on the change in his report because it does not affect his opinion as to consistency.⁶ However, an accounting change of this type having a material effect on the financial statements may require disclosure in a note to the financial statements.⁷

Error Correction Not Involving Principle

.13 Correction of an error in previously issued financial statements resulting from mathematical mistakes, oversight, or misuse of facts that existed at the time the financial statements were originally prepared does not involve the consistency standard if no element of accounting principles or their application is included. Accordingly, the independent auditor need not recognize the correction in his opinion as to consistency.⁸

Changes in Classification and Reclassifications

.14 Classifications in the current financial statements may be different from classifications in the prior year's financial statements. Although changes in classification are usually not of sufficient importance to necessitate disclosure, material changes in classification should be indicated and explained in the financial statements or notes. These changes and material reclassifications

⁵ See paragraph 11 of Accounting Principles Board Opinion No. 20 [AC section A06.110].

⁶ Footnote deleted.

⁷ See paragraph 33 of Accounting Principles Board Opinion No. 20 [AC section A06.132].

⁸ If the independent auditor had previously reported on the financial statements containing the error, he should refer to section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

made in previously issued financial statements to enhance comparability with current financial statements ordinarily would not affect the independent auditor's opinion as to consistency and need not be referred to in his report.

Variations in Presentation of Statement of Changes in Financial Position

.15 In paragraph 8 of APB Opinion 19 [AC Section F40.102], the Accounting Principles Board concluded that "the statement summarizing changes in financial position should be based on a broad concept embracing all changes in financial position." In paragraph 9 of that opinion, however, the board recognized "the need for flexibility in form, content, and terminology" in the statement of changes. Accordingly, there may be variations between periods in the format of the statement of changes (such as changing to or from a balanced form) and in the terms used to express changes in financial position (such as changing from "working capital" to "cash" or "cash and cash equivalents"). Such variations when adequately disclosed in the financial statements and applied retroactively to all prior periods presented ordinarily would not affect the independent auditor's opinion regarding consistency and need not be referred to in the independent auditor's report. [As amended, (by replacing paragraph .15 with a new paragraph and deleting paragraph .16), effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

Substantially Different Transactions or Events

.16 Accounting principles are adopted when events or transactions first become material in their effect. Such adoption, as well as modification or adoption of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring, do not involve the consistency standard although disclosure in the notes to the financial statements may be required. [Formerly paragraph .17, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Changes Expected to Have a Material Future Effect

.17 If an accounting change has no material effect on the financial statements in the current year, but the change is reasonably certain to have substantial effect in later years, the change should be disclosed in the notes to the financial statements whenever the statements of the period of change are presented, but the independent auditor need not recognize the change in his opinion as to consistency. [Formerly paragraph .18, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Disclosure of Changes Not Affecting Consistency

.18 While the matters discussed in paragraphs .12—.15 and .16—.17 do not require recognition in the independent auditor's report as to consistency, the auditor should qualify his report as to the disclosure matter if necessary

disclosures are not made. (See section 431.) [Reference changed by issuance of Statement on Auditing Standards No. 32. Formerly paragraph .19, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Periods to Which the Consistency Standard Relates

.19 When the independent auditor reports only on the current period, he should report on the consistency of the application of accounting principles in relation to the preceding period, regardless of whether financial statements for the preceding period are presented. (The term "current period" means the most recent year, or period of less than one year, upon which the independent auditor is reporting.) When the independent auditor reports on two or more years, he should report on the consistency of the application of accounting principles between such years and also on the consistency of such years with the year prior thereto if such prior year is presented with the financial statements being reported upon. [Formerly paragraph .20, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Consistency Expression

.20 When the independent auditor is expressing an opinion on the financial statements of a single year, the phrase "on a basis consistent with that of the preceding year" is appropriate; however, if the financial statements are for the initial accounting period of a company, he should not refer to consistency because no previous period exists with which to make a comparison. If the auditor's report covers two or more years, language similar to "applied on a consistent basis" should be used. In such cases, if the year preceding the earliest year being reported upon is also presented, language similar to "consistently applied during the period and on a basis consistent with that of the preceding year" should be used. [Formerly paragraph .21, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

[The next page is 521.]

AU Section 431***Adequacy of Disclosure
in Financial Statements***

(Supersedes Statement on Auditing Standards No. 1,
section 430)

Source: SAS No. 32.

Issue date, unless otherwise indicated: October, 1980.

.01 The third standard of reporting is:

Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

.02 The presentation of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. An independent auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he is aware at the time.

.03 If management omits from the financial statements, including the accompanying notes, information that is required by generally accepted accounting principles, the auditor should express a qualified or an adverse opinion and should provide the information in his report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards.¹ In this context, *practicable* means that the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information. For example, the auditor would not be expected to prepare a basic financial statement or segment information and include it in his report when management omits such information.

.04 In considering the adequacy of disclosure, and in other aspects of his examination, the auditor uses information received in confidence from the client. Without such confidence, the auditor would find it difficult to obtain information necessary for him to form an opinion on financial statements. Thus, the auditor should not ordinarily make available, without the client's consent, information that is not required to be disclosed in financial statements to comply with generally accepted accounting principles (see AICPA Code of Professional Ethics, Rule 301 [ET section 301.01]).

[The next page is 541.]

¹ An independent auditor may participate in preparing financial statements, including accompanying notes. The financial statements, including accompanying notes, however, remain the representations of management, and such participation by the auditor does not require him to modify his report (see section 110.02).

AU Section 435

Segment Information^{*1}

Source: SAS No. 21.

Issue date, unless otherwise indicated: December, 1977.

.01 Statement of Financial Accounting Standards No. 14 [AC section S20], *Financial Reporting for Segments of a Business Enterprise*, requires the inclusion of certain information about an entity's operations in different industries, its foreign operations and export sales, and its major customers (referred to in this section as "segment information") in annual financial statements that are intended to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Disclosure of segment information requires the disaggregation of certain significant elements of an entity's financial statements, such as revenue, operating profit or loss, identifiable assets, depreciation, and capital expenditures. This section provides guidance to an auditor in examining and reporting on financial statements that are required to include segment information in conformity with FASB Statement No. 14 [AC section S20].

.02 Segment information is one of the disclosures required by generally accepted accounting principles as an integral part of financial statements. The purpose of segment information is stated in paragraph 5 of FASB Statement No. 14 [AC section S20.106]:

The purpose of the information required to be reported by this Statement is to assist financial statement users in analyzing and understanding the enterprise's financial statements by permitting better assessment of the enterprise's past performance and future prospects information prepared in conformity with this Statement may be of limited usefulness for comparing a segment of one enterprise with a similar segment of another enterprise.

Auditor's Objective

.03 The objective of auditing procedures applied to segment information is to provide the auditor with a reasonable basis for concluding whether the information is presented in conformity with FASB Statement No. 14 [AC section S20] in relation to the financial statements taken as a whole. The auditor examining financial statements in accordance with generally accepted auditing standards considers segment information, as other informative disclosures, in relation to the financial statements taken as a whole, and is not required to apply auditing procedures that would be necessary to express a separate opinion on the segment information.

Auditing Procedures

.04 Paragraphs .05—.07 of this section provide guidance as to auditing procedures when financial statements include segment information. If an

^{*} See FASB Statement No. 21 [AC section S20.101—.103 and S20.407], *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*.

¹ The meaning of the term "segment information" in this section differs from that of the term "segment" in footnote 2, section 621, *Special Reports*.

entity represents to the auditor that it does not have industry segments, foreign operations, export sales, or major customers required to be disclosed by FASB Statement No. 14 [AC section S20], the auditor should follow the guidance in paragraph .15 of this section.

.05 The auditor applies the concept of materiality, discussed in section 150.04, in determining the nature, timing, and extent of auditing procedures to be applied in an examination of financial statements. Materiality of segment information is evaluated primarily by relating the dollar magnitude of the information to the financial statements taken as a whole. However, as with other elements of financial statements, the materiality of segment information does not depend entirely on relative size; the concept involves qualitative as well as quantitative judgments. (A discussion of materiality as it relates to the auditor's report is included in paragraph .08 of this section.)

.06 In planning his examination, it may be necessary for the auditor to modify or redirect selected audit tests to be applied to the financial statements taken as a whole. For example, the auditor may decide to select inventories for physical observation on the basis of industry segments or geographic areas. Factors such as the following should be considered by the auditor in determining whether his procedures should be modified or redirected:

- a. Internal accounting control and the degree of integration, centralization, and uniformity of the accounting records.
- b. The nature, number, and relative size of industry segments and geographic areas.
- c. The nature and number of subsidiaries or divisions in each industry segment and geographic area.
- d. The accounting principles used for the industry segments and geographic areas.

In any event, the tests of underlying accounting records normally applied in an examination of financial statements should include a consideration of whether the entity's revenue, operating expenses, and identifiable assets are appropriately classified among industry segments and geographic areas.

.07 In addition, the auditor should apply the following procedures to segment information presented in financial statements:

- a. Inquire of management concerning its methods of determining segment information, and evaluate the reasonableness of those methods in relation to the factors identified in FASB Statement No. 14 [AC section S20] for making those determinations.²
- b. Inquire as to the bases of accounting for sales or transfers between industry segments and between geographic areas, and test, to the extent considered necessary, those sales or transfers for conformity with the bases of accounting disclosed.
- c. Test the disaggregation of the entity's financial statements into segment information. The tests should include (1) an evaluation of the entity's application of the various percentage tests specified in paragraphs 15-20 and 31-39 of FASB Statement No. 14 [AC sections S20.119—.126 and S20.137—.144], and (2) application of analytical review procedures to the segment information to identify and provide a basis for inquiry about relationships and individual items that appear to be unusual. Analytical review procedures, for purposes of this section, consist of (a) comparison of the segment information with comparable information for the immediately preceding year, (b) comparison of the segment information with any available related budgeted information for the current year, and (c) study of the relationships of elements of the segment information that would be expected to conform to a predictable pattern based on the entity's experience (for example, operating profit as a percentage of both total revenue and identifiable assets by industry segment or geographic area). In applying these procedures, the auditor should consider the types of matters that in the preceding year have required accounting adjustments of segment information. [As modified, November 1979, by the Auditing Standards Board.]
- d. Inquire as to the methods of allocating operating expenses incurred and identifiable assets used jointly by two or more segments, evaluate whether those methods are reasonable, and test the allocations to the extent considered necessary.
- e. Determine whether the segment information has been presented consistently from period to period and, if not, whether the nature and effect of the inconsistency are disclosed and, if applicable, whether the information has been retroactively restated in conformity with paragraph 40 of FASB Statement No. 14 [AC section S20.146].

² Paragraphs 11-21 and Appendix D of FASB Statement No. 14 [AC sections S20.113—.127 and S20.409] discuss how an entity's industry segments and reportable segments should be determined. Paragraph 34 of that Statement [AC section S20.140] describes factors to be considered in grouping the countries in which an entity operates into geographic areas, and paragraphs 36 and 39 [AC section S20.142] describe criteria for disclosing export sales and major customers, respectively.

Reporting

.08 The auditor's standard report on financial statements prepared in conformity with generally accepted accounting principles implicitly applies to segment information included in those statements in the same manner that it applies to other informative disclosures in the financial statements that are not clearly marked as "unaudited."³ The auditor's standard report would not refer to segment information unless his examination revealed a misstatement or omission, or a change in accounting principle, relating to the segment information that is material in relation to the financial statements taken as a whole, or the auditor was unable to apply the auditing procedures that he considered necessary in the circumstances. The auditor should consider qualitative as well as quantitative factors in evaluating whether such a matter is material to the financial statements taken as a whole. The significance of a matter to a particular entity (for example, a misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity), the pervasiveness of a matter (for example, whether it affects the amounts and presentation of numerous items in the segment information), and the impact of a matter (for example, whether it distorts the trends reflected in the segment information) should all be considered in judging whether a matter relating to segment information is material to the financial statements taken as a whole. Accordingly, situations may arise in practice where the auditor will conclude that a matter relating to segment information is material to the financial statements taken as a whole even though, in his judgment, it is quantitatively immaterial to those financial statements.

Misstatement or Omission of Segment Information

.09 If the auditor's examination reveals a misstatement in the segment information that is material in relation to the financial statements taken as a whole and that misstatement is not corrected, the auditor should modify⁴ his opinion on the financial statements because of a departure from generally accepted accounting principles. The following is an example of an auditor's report qualified because of a misstatement of segment information.

(Explanatory paragraph)

With respect to the segment information in Note X, \$..... of the operating expenses of Industry A were incurred jointly by Industries A and

³ If an entity discloses comparative segment information for fiscal years beginning prior to December 15, 1976, that information should be clearly marked as "unaudited" unless the auditor has applied to that segment information the auditing procedures set forth in this section. If the auditor concludes, on the basis of facts known to him, that segment information marked "unaudited" is not in conformity with FASB Statement No. 14 [AC section S20] in relation to the financial statements taken as a whole, he should follow the guidance in section 504. [Reference changed by the issuance of Statement on Auditing Standards No. 26, *Association with Financial Statements*.]

⁴ The term "modify" in this context means to express a qualified or an adverse opinion.

B. In our opinion, Statement No. 14 of the Financial Accounting Standards Board requires that those operating expenses be allocated between Industries A and B. The effect of the failure to allocate those operating expenses has been to understate the operating profit of Industry A and to overstate the operating profit of Industry B by an amount that has not been determined.

(Opinion paragraph)

In our opinion, except for the effects of not allocating certain common operating expenses between Industries A and B, as discussed in the preceding paragraph, the financial statements referred to above present fairly . . .

.10 If the entity declines to include in the financial statements part or all of the segment information that the auditor believes, based on his knowledge of the entity's business, is required to be disclosed, the auditor should modify his opinion on the financial statements because of inadequate disclosure and should describe the type of information omitted.⁵ The auditor is not required to provide the omitted information in his report.⁶ The following is an example of an auditor's report qualified because of an omission of segment information.

(Explanatory paragraph)

The Company declined to present segment information for the year ended December 31, 19XX. In our opinion, presentation of segment information concerning the Company's operations in different industries, its foreign operations and export sales, and its major customers is required by Statement No. 14 of the Financial Accounting Standards Board. The omission of segment information results in an incomplete presentation of the Company's financial statements.

(Opinion paragraph)

In our opinion, except for the omission of segment information, as discussed in the preceding paragraph, the financial statements referred to above present fairly . . .

Consistency

.11 Paragraph 67 of FASB Statement No. 14, states:

... consistency from period to period in the methods by which an enterprise's segment information is prepared and presented is as important as consistency in the application of the accounting principles used in preparing the enterprise's consolidated financial statements.

An inconsistency in segment information may occur because of—

⁵ This requirement is applicable whether or not the financial statements include a statement of changes in financial position.

⁶ In view of the provisions of this sentence, the following changes are made: The third sentence of section 545.01 (see Appendix G), and the second sentence of section 509.17 (see Appendix G) are amended to read:

If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or an adverse opinion because of the departure from those principles and should provide the information in his report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards.

The first two sentences of section 545.05 (see Appendix G) are amended to read:

If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should provide the information in his report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards. The auditor is not required to prepare a basic financial statement (a statement of changes in financial position for one or more years) and include it in his report if an entity declines to present the statement.

- a. A change in the bases of accounting for sales or transfers between industry segments or between geographic areas, or in the methods of allocating operating expenses or identifiable assets among industry segments or geographic areas (paragraphs 23, 24, and 35a of FASB Statement No. 14 [AC sections S20.129—.130 and S20.141a]).
- b. A change in the method of determining or presenting a measure of profitability for some or all of the segments (paragraphs 25 and 35b of FASB Statement No. 14 [AC sections S20.131 and S20.141b]).
- c. A change in accounting principle as discussed in APB Opinion No. 20 [AC section A06], *Accounting Changes* (paragraph 27d of FASB Statement No. 14 [AC section S20.133d]).
- d. A change requiring retroactive restatement as discussed in paragraph .12 of this section.

.12 Paragraph 40 of FASB Statement No. 14 [AC section S20.146] requires that segment information for prior periods that is disclosed in comparative financial statements be retroactively restated if—

- a. The financial statements of the entity as a whole have been retroactively restated.
- b. The method of grouping products and services into industry segments or of grouping foreign operations into geographic areas is changed and the change affects the segment information disclosed.

.13 FASB Statement No. 14 [AC section S20] requires that the nature and effect of the changes indicated in paragraphs .11 and .12 be disclosed in the period of the change. If the nature and effect of a change are not disclosed or, if applicable, the segment information is not retroactively restated, the auditor should modify his opinion because of the departure from generally accepted accounting principles. The following is an example of an auditor's report qualified because of an entity's failure to disclose the nature and effect of a change in the basis of accounting for sales between industry segments.

(Explanatory paragraph)

In 19XX, the Company changed the basis of accounting for sales between its industry segments from the market price method to the negotiated price method, but declined to disclose the nature and effect of this change on its segment information. In our opinion, disclosure of the nature and effect of

this change, which has not been determined, is required by Statement No. 14 of the Financial Accounting Standards Board.

(Opinion paragraph)

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly . . .

.14 A modification of the auditor's report as to consistency is not required for the changes indicated in paragraphs .11 and .12 except for a change in accounting principle that affects the financial statements taken as a whole (paragraph .11c), in which case the auditor should also follow the guidance in sections 420 and 546.

Scope Limitation

.15 An entity may represent to the auditor that it does not have industry segments, foreign operations, export sales, or major customers required to be disclosed by FASB Statement No. 14 [AC section S20]. The auditor ordinarily would be able to conclude, based on his knowledge of the entity's business, whether the entity has such industry segments, foreign operations, export sales, or major customers. If the auditor is unable to reach a conclusion based on that knowledge and the entity declines to develop the information he considers necessary to reach a conclusion, the auditor should indicate in the scope paragraph of his report the limitation on his examination and should qualify his opinion on the financial statements taken as a whole. The following is an example of an auditor's report qualified because of the auditor's inability to conclude whether the entity is required to present segment information.

(Scope paragraph)

. . . Except as explained in the following paragraph, our examination . . . and such other auditing procedures as we considered necessary in the circumstances.

(Explanatory paragraph)

The Company has not developed the information we consider necessary to reach a conclusion as to whether the presentation of segment information concerning the Company's operations in different industries, its foreign operations and export sales, and its major customers is necessary to conform with Statement No. 14 of the Financial Accounting Standards Board.

(Opinion paragraph)

In our opinion, except for the possible omission of segment information, the financial statements referred to above present fairly . . .

.16 The auditor should also qualify his opinion on the financial statements taken as a whole if he is unable to apply to reported segment information the auditing procedures that he considers necessary in the circumstances. The following is an example of an auditor's report qualified because the entity has specified that the auditor should not apply to reported segment information the auditing procedures that he considered necessary in the circumstances.

(Scope paragraph)

... Except as explained in the following paragraph, our examination ... and such other auditing procedures as we considered necessary in the circumstances.

(Explanatory paragraph)

In accordance with the Company's request, our examination of the financial statements did not include the segment information presented in Note X concerning the Company's operations in different industries, its foreign operations and export sales, and its major customers.

(Opinion paragraph)

In our opinion, except for the effects of such adjustments or disclosures, if any, as might have been determined to be necessary had we applied to the segment information the procedures we considered necessary in the circumstances, the financial statements referred to above present fairly ...

Reporting Separately on Segment Information

.17 The auditor may be requested to report separately on segment information, either in a special report or as part of his report on the financial statements taken as a whole. In such an engagement, the measurement of materiality should be related to the segment information itself rather than to the financial statements taken as a whole. Consequently, an examination of segment information for the purpose of reporting on it separately is more extensive than if the same information were considered in conjunction with an examination of the financial statements taken as a whole.

.18 Paragraphs .10—.13 of section 621, *Special Reports*, provide guidance that is applicable to reporting separately on segment information. However, all of the generally accepted auditing standards, including the first and second standards of reporting, are applicable because FASB Statement No. 14 [AC section S20] establishes generally accepted accounting principles for the presentation of segment information. Thus, whether segment information is presented voluntarily or because it is required, the auditor's report on such information should state whether it is presented in accordance with generally accepted accounting principles consistently applied.

AU Section 500

THE FOURTH STANDARD OF REPORTING

... association with financial statements ... reports on audited financial statements ... dating of independent auditor's report ... reporting on financial statements prepared for use in other countries ... part of examination made by other independent auditors ... lack of conformity with GAAP ... other information in documents containing audited financial statements ... reporting on information in auditor-submitted documents ... reporting on condensed financial statements and selected financial data ... supplementary information ... subsequent events ... subsequent discovery of facts ...

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AU Section 504

Association With Financial Statements

(Supersedes Statement on Auditing Standards No. 1, Sections 516, 517, and 518 and Statement on Auditing Standards No. 15, paragraphs 13—15)¹

Sources: SAS No. 26; SAS No. 35.

See section 9504 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1979.

.01 The fourth standard of reporting is:

The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

The objective of the fourth reporting standard is to prevent misinterpretation of the degree of responsibility the accountant assumes when his name is associated with financial statements.

.02 This section defines *association* as that term is used in the fourth reporting standard. It provides guidance to an accountant associated with the financial statements of a public entity or with a nonpublic entity's financial statements that he has been engaged to examine in accordance with generally accepted auditing standards.²

.03 An accountant is associated with financial statements when he has consented to the use of his name in a report, document, or written communication containing the statements.³ Also, when an accountant submits to his

¹ This section amends section 509 (see Appendix G) by the addition of the following to footnote 10:

If an accountant is engaged to conduct an examination of the financial statements of a nonpublic entity in accordance with generally accepted auditing standards, but is requested to change the engagement to a review or compilation of the statements, he should look to the guidance in Statements on Standards for Accounting and Review Services 1, paragraphs 44—49 [AR section 100.44—.49].

² For purposes of this section, a public entity is any entity (a) whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market, or (c) a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (a) or (b). Statements on Standards for Accounting and Review Services provide guidance in connection with the unaudited financial statements or other unaudited financial information of a nonpublic entity.

³ However, this section does not apply to data, such as tax returns, prepared solely for submission to taxing authorities.

client or others financial statements that he has prepared or assisted in preparing, he is deemed to be associated even though the accountant does not append his name to the statements. Although the accountant may participate in the preparation of financial statements, the statements are representations of management, and the fairness of their presentation in conformity with generally accepted accounting principles is management's responsibility.

.04 An accountant may be associated with audited or unaudited financial statements. Financial statements are audited if the accountant has applied auditing procedures sufficient to permit him to report on them as described in section 509, *Reports on Audited Financial Statements* (see Appendix G). The unaudited interim financial statements (or financial information) of a public entity are reviewed when the accountant has applied procedures sufficient to permit him to report on them as described in section 722,* *Review of Interim Financial Information*.

Disclaimer of Opinion on Unaudited Financial Statements

.05 When an accountant is associated with the financial statements of a public entity, but has not audited or reviewed⁴ such statements, the form of report to be issued is as follows:

The accompanying balance sheet of X Company as of December 31, 19X1, and the related statements of income, retained earnings, and changes in financial position for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

(Signature and date)

This disclaimer of opinion is the means by which the accountant complies with the fourth standard of reporting when associated with unaudited financial statements in these circumstances. The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited. When an accountant issues this form of disclaimer of opinion, he has no responsibility to apply any procedures beyond reading the financial statements for obvious material errors. Any procedures that may have been applied should not be described, except in the limited circumstances set forth in paragraphs .18—.20. Describing procedures that may have been applied might cause the reader to believe the financial statements have been audited or reviewed.

.06 If the accountant is aware that his name is to be included in a client-prepared written communication of a public entity containing financial statements that have not been audited or reviewed, he should request (a) that his name not be included in the communication or (b) that the financial statements be marked as unaudited and that there be a notation that he does not express an opinion on them. If the client does not comply, the accountant should advise the client that he has not consented to the use of his name and should consider what other actions might be appropriate.⁵

* Reference changed by issuance of SAS No. 36.

⁴ When a public entity does not have its annual financial statements audited, an accountant may be requested to review its annual or interim financial statements. In those circumstances, an accountant may make a review and look to the guidance in Statements on Standards for Accounting and Review Services for the standards and procedures and form of report applicable to such an engagement.

⁵ In considering what actions, if any, may be appropriate in the circumstances, the accountant may wish to consult his legal counsel.

Disclaimer of Opinion on Unaudited Financial Statements Prepared on a Comprehensive Basis of Accounting

.07 When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, he should follow the guidance provided by paragraph .05, except that he should modify the identification of financial statements in his disclaimer of opinion (see section 621.02—.08, *Special Reports*).⁶ For example, a disclaimer of opinion on cash-basis statements might be worded as follows:

The accompanying statement of assets and liabilities resulting from cash transactions of XYZ Corporation as of December 31, 19X1, and the related statement of revenues collected and expenses paid during the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

(Signature and date)

A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

Disclaimer of Opinion When Not Independent

.08 The second general standard requires that "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." The independent public accountant must be without bias with respect to the client; otherwise, he would lack that impartiality necessary for the dependability of his findings. Whether the accountant is independent is something he must decide as a matter of professional judgment.

.09 When an accountant is not independent, any procedures he might perform would not be in accordance with generally accepted auditing standards, and he would be precluded from expressing an opinion on such statements. Accordingly, he should disclaim an opinion with respect to the financial statements and should state specifically that he is not independent.

.10 If the financial statements are those of a nonpublic entity, the accountant should look to the guidance in Statements on Standards for Accounting and Review Services. In all other circumstances, regardless of the extent of procedures applied, the accountant should follow the guidance in paragraph .05, except that the disclaimer of opinion should be modified to state specifically that he is not independent. The reasons for lack of independence and any procedures he has performed should not be described; including such matters might confuse the reader concerning the importance of the impairment of independence. An example of such a report is as follows:

We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19X1, and the related statements of income, retained earnings, and changes in financial position for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

(Signature and date)

⁶ Reference to generally accepted accounting principles in this section includes, where applicable, another comprehensive basis of accounting.

Circumstances Requiring a Modified Disclaimer

.11 If the accountant concludes on the basis of facts known to him that the unaudited financial statements on which he is disclaiming an opinion are not in conformity with generally accepted accounting principles, which include adequate disclosure, he should suggest appropriate revision; failing that, he should describe the departure in his disclaimer of opinion. This description should refer specifically to the nature of the departure and, if practicable, state the effects on the financial statements or include the necessary information for adequate disclosure.

.12 When the effects of the departure on the financial statements are not reasonably determinable, the disclaimer of opinion should so state. When a departure from generally accepted accounting principles involves inadequate disclosure, it may not be practicable for the accountant to include the omitted disclosures in his report. For example, when management has elected to omit substantially all of the disclosures, the accountant should clearly indicate that in his report, but the accountant would not be expected to include such disclosures in his report.

.13 If the client will not agree to revision of the financial statements or will not accept the accountant's disclaimer of opinion with the description of the departure from generally accepted accounting principles, the accountant should refuse to be associated with the statements and, if necessary, withdraw from the engagement.

Reporting on Audited and Unaudited Financial Statements in Comparative Form

.14 When unaudited financial statements are presented in comparative form with audited financial statements in documents filed with the Securities and Exchange Commission, such statements should be clearly marked as "unaudited" but should not be referred to in the auditor's report.

.15 When unaudited financial statements are presented in comparative form with audited financial statements in any other document, the financial statements that have not been audited should be clearly marked to indicate their status and either (a) the report on the prior period should be reissued (see section 530.06—.08)⁷ or (b) the report on the current period should include as a separate paragraph an appropriate description of the responsibility assumed for the financial statements of the prior period (see paragraphs .16 and .17). Either reissuance or reference in a separate paragraph is acceptable; in both circumstances, the accountant should consider the current form and manner of presentation of the financial statements of the prior period in light of the information of which he has become aware during his current engagement.

.16 When the financial statements of the prior period have been audited and the report on the current period is to contain a separate paragraph, it should indicate (a) that the financial statements of the prior period were examined previously, (b) the date of the previous report, (c) the type of opinion expressed previously, (d) if the opinion was other than unqualified, the substantive reasons therefor, and (e) that no auditing procedures were performed after the date of the previous report. An example of such a separate paragraph is as follows:

The financial statements for the year ended December 31, 19X1, were examined by us (other accountants) and we (they) expressed an unqualified opinion on them in our (their) report dated March 1, 19X2, but we (they) have not performed any auditing procedures since that date.

.17 When the financial statements of the prior period have not been audited and the report on the current period is to contain a separate paragraph, it should include (a) a statement of the service performed in the prior period, (b) the date of the report on that service, (c) a description of any material modifications noted in that report, and (d) a statement that the service was less in scope than an audit and does not provide the basis for the expression of an opinion on the financial statements taken as a whole. When the financial statements are those of a public entity, the separate paragraph should include a disclaimer of opinion (see paragraph .05) or a description of a review. When the financial statements are those of a nonpublic entity and the financial statements were compiled or reviewed, the separate paragraph should contain an appropriate description of the compilation or review. For example, a separate paragraph describing a review might be worded as follows:

The 19X1 financial statements were reviewed by us (other accountants) and our (their) report thereon, dated March 1, 19X2, stated we (they) were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

⁷ For reissuance of a compilation or review report, see Statements on Standards for Accounting and Review Services.

A separate paragraph describing a compilation might be worded as follows:

The 19X1 financial statements were compiled by us (other accountants) and our (their) report thereon, dated March 1, 19X2, stated we (they) did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

Negative Assurance

.18 When an accountant, for whatever reason, disclaims an opinion on financial statements his disclaimer should not be contradicted by the inclusion of expressions of assurance on the absence of knowledge of departures from generally accepted accounting principles except as specifically recognized as appropriate in applicable standards established by the American Institute of Certified Public Accountants.

.19 Negative assurances, for example, are permissible in letters for underwriters in which the independent auditor reports on limited procedures followed with respect to unaudited financial statements or other financial data pertinent to a registration statement filed with the Securities and Exchange Commission (see section 634, * *Letters for Underwriters*).

.20 An accountant may also be requested to describe limited procedures followed with respect to unaudited financial statements of a public entity, similar to those performed for a letter for underwriters, in connection with a proposed acquisition and give negative assurance regarding the financial statements taken as a whole. Acceptance and performance of such an engagement is appropriate if the applicable requirements for a letter for underwriters are met (see section 634*). When an accountant is requested to report on the results of applying agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement in connection with a proposed acquisition, he should report in accordance with section 622.** [As amended, April 1981, by Statement on Auditing Standards No. 35.] (See section 622.)

[The next page is 651.]

* [Reference number 631, formerly 630, changed by the issuance of Statement on Auditing Standards No. 38 (superseded). Reference number 634, formerly 631, changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

** [Reference changed by issuance of Statement on Auditing Standards No. 35.] (See section 622.)

AU Section 508

Reports on Audited Financial Statements

(Supersedes sections 505, 509, 542, 545, and 546
[See Appendix G])

Source: SAS No. 58.

Effective for reports issued or reissued on or after January 1, 1989,
unless otherwise indicated.

Introduction

.01 This section applies to auditors' reports issued in connection with audits¹ of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides example reports.

.02 This section does not apply to unaudited financial statements as described in section 504, *Association With Financial Statements*, nor does it apply to reports on incomplete financial information or other special presentations as described in section 621, *Special Reports*.

.03 Justification for the expression of the auditor's opinion rests on the conformity of his audit with generally accepted auditing standards and on his findings. Generally accepted auditing standards include four standards of reporting.² This section is concerned primarily with the relationship of the fourth reporting standard to the language of the auditor's report.

.04 The fourth standard of reporting is as follows:

The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the audit, if any, and the degree of responsibility he is taking.

¹ An audit, for purposes of this section, is defined as an examination of historical financial statements performed in accordance with generally accepted auditing standards in effect at the time the audit is performed. Generally accepted auditing standards include the ten standards as well as the Statements on Auditing Standards that interpret those standards. In some cases, regulatory authorities may have additional requirements applicable to entities under their jurisdiction and auditors of such entities should consider those requirements.

² This section revises the second standard of reporting as follows:

The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period. Previously, the second standard required the auditor's report to state whether accounting principles had been consistently applied. As revised, the second standard requires the auditor to add an explanatory paragraph to his report only if accounting principles have not been applied consistently. (See section 420, *Consistency of Application of Generally Accepted Accounting Principles*.) Section 420.34—.36 provide reporting guidance under these circumstances.

.05 The objective of the fourth standards is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his name is associated with financial statements. Reference in the fourth reporting standard to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. (Paragraph .74 discusses the fourth standard of reporting as it applies to comparative financial statements.) The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant.

.06 The auditor's report is customarily issued in connection with an entity's basic financial statements—balance sheet, statement of income, statement of retained earnings and statement of cash flows. Each financial statement audited should be specifically identified in the introductory paragraph of the auditor's report. If the basic financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the introductory paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are part of the presentation of financial position, results of operations, and cash flows.

The Auditor's Standard Report

.07 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards.

.08 The auditor's standard report identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion in a separate opinion paragraph. The basic elements of the report are the following:

- a. A title that includes the word *independent*³
- b. A statement that the financial statements identified in the report were audited
- c. A statement that the financial statements are the responsibility of the Company's management⁴ and that the auditor's responsibility is to express an opinion on the financial statements based on his audit
- d. A statement that the audit was conducted in accordance with generally accepted auditing standards
- e. A statement that generally accepted auditing standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement
- f. A statement that an audit includes—

³ This section does not require a title for an auditor's report if the auditor is not independent. See section 504, *Association With Financial Statements*, for guidance on reporting when the auditor is not independent.

⁴ In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility.

- (1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements
- (2) Assessing the accounting principles used and significant estimates made by management
- (3) Evaluating the overall financial statement presentation⁵
- g. A statement that the auditor believes that his audit provides a reasonable basis for his opinion
- h. An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles
- i. The manual or printed signature of the auditor's firm
- j. The date⁶ of the audit report

The form of the auditor's standard report on financial statements covering a single year is as follows:

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

The form of the auditor's standard report on comparative financial statements⁷ is as follows:

⁵ Section 411, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, paragraphs .03 and .04, discuss the auditor's evaluation of the overall presentation of the financial statements.

⁶ For guidance on dating the auditor's report, see section 530, *Dating of the Independent Auditor's Report*.

⁷ If statements of income, retained earnings, and cash flows are presented on a comparative basis for one or more prior periods, but the balance sheet(s) as of the end of one (or more) of the prior period(s) is not presented, the phrase "for the years then ended" should be changed to indicate that the auditor's opinion applies to each period for which statements of income, retained earnings, and cash flows are presented, such as "for each of the three years in the period ended [date of latest balance sheet]."

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

.09 The report may be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to audit the financial statements of a company that is not his client; in such a case, the report is customarily addressed to the client and not to the directors or stockholders of the company whose financial statements are being audited.

.10 This section also discusses the circumstances that may require the auditor to depart from the standard report and provides reporting guidance in such circumstances. This section is organized by type of opinion that the auditor may express in each of the various circumstances presented; this section describes what is meant by the various audit opinions:

- *Unqualified opinion.* An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. This is the opinion expressed in the standard report discussed in paragraph .08.
- *Explanatory language added to the auditor's standard report.* Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his report.
- *Qualified opinion.* A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial

position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.

- *Adverse opinion.* An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles.
- *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.

These opinions are discussed in greater detail throughout the remainder of this section.

Explanatory Language Added to the Auditor's Standard Report

.11 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory⁸ paragraph (or other explanatory language) to his standard report.⁹ These circumstances include:

- a. The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13).
- b. To prevent the financial statements from being misleading because of unusual circumstances, the financial statements contain a departure from an accounting principle promulgated by a body designated by the AICPA Council to establish such principles (paragraphs .14 and .15).
- c. The financial statements are affected by uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation at the date of the auditor's report (paragraphs .16—.33).
- d. There is substantial doubt about the entity's ability to continue as a going concern.¹⁰
- e. There has been a material change between periods in accounting principles or in the method of their application (paragraphs .34—.36).
- f. Certain circumstances relating to reports on comparative financial statements exist (paragraphs .77, .78, and .81—.83).
- g. Selected quarterly financial data required by SEC Regulation S-K has been omitted or has not been reviewed. (See section 722, *Review of Interim Financial Information*, paragraph .29.)
- h. Supplementary information required by the Financial Accounting Standards Board (FASB) or the Governmental Accounting Standards Board (GASB) has been omitted, the presentation of such information departs materially from FASB or GASB guidelines, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial

⁸ Unless otherwise required by the provisions of this section, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report.

⁹ See footnote 3.

¹⁰ Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, describes the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and, when applicable, to consider the adequacy of financial statement disclosure and to include an explanatory paragraph in his report to reflect his conclusions.

doubts about whether the supplementary information conforms to FASB or GASB guidelines. (See section 558, *Required Supplementary Information*, paragraph .02.)

- i. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements. (See section 550, *Other Information in Documents Containing Audited Financial Statements*, paragraph .04.)

In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (paragraph .37).

Opinion Based in Part on Report of Another Auditor

.12 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his opinion, he should disclose this fact in the introductory paragraph of his report and should refer to the report of the other auditor in expressing his opinion. These references indicate division of responsibility for performance of the audit. (See section 543, *Part of Examination Made by Other Independent Auditors*.)

- .13 An example of a report indicating a division of responsibility follows:

Independent Auditor's Report

We have audited the consolidated balance sheets of ABC Company as of December 31, 19X2 and 19X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of \$_____ and \$_____ as of December 31, 19X2 and 19X1, respectively, and total revenues of \$_____ and \$_____ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Departure From a Promulgated Accounting Principle

.14 Rule 203 [ET section 203.01] of the Code of Professional Conduct of the AICPA states:

A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally

accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

.15 When the circumstances contemplated by Rule 203 [ET section 203.01] are present, the auditor's report should include, in a separate paragraph or paragraphs, the information required by the rule. In such a case, it is appropriate for him to express an unqualified opinion with respect to the conformity of the financial statements with generally accepted accounting principles unless there are other reasons, not associated with the departure from a promulgated principle, not to do so. (See section 411, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report.*)

Uncertainties

.16 This section (paragraphs .17 through .33) provides guidance on the auditor's considerations in deciding whether an explanatory paragraph needs to be added to his report because of a matter involving an uncertainty.¹¹ Such uncertainties include, but are not limited to, contingencies covered by FASB Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies* [AC section C59]. This section also provides guidance on distinguishing between (a) situations involving uncertainties for which an explanatory paragraph in the auditor's report is necessary, and (b) those for which a qualified opinion or a disclaimer of opinion is necessary because of a scope limitation or those for which a qualified or adverse opinion is necessary because of a departure from generally accepted accounting principles.

Distinguishing Between Situations That May Require an Explanatory Paragraph and Those That May Require a Departure From an Unqualified Opinion

.17 **Uncertainties and scope limitations.** If the auditor has not obtained sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, he should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation (see paragraphs .40 through .48). In making that determination, the auditor should consider the distinction between a scope limitation (described below) and the need for an explanatory paragraph because of an uncertainty (see paragraphs .23 through .26).

.18 A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time sufficient evidential matter concerning its outcome would be expected to become available. A qualification or disclaimer of opinion because of a scope limitation is appropriate when

¹¹ The addition of an explanatory paragraph to the auditor's report to identify an uncertainty, as contemplated by this section, serves adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner, and the auditor's report should give all the substantive reasons for his disclaimer of opinion.

sufficient evidential matter does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management. However, the auditor should recognize that, although sufficient evidential matter concerning the outcome of an uncertainty cannot be expected to exist at the time of the audit (because the resolution, and therefore the evidence, is prospective), it is management's responsibility when preparing the financial statements in conformity with generally accepted accounting principles to analyze relevant existing conditions and their effect on the financial statements. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis.

.19 *Uncertainties and departures from generally accepted accounting principles.* Departures from generally accepted accounting principles involving uncertainties generally fall into one of the following categories:

- Inadequate disclosure (paragraph .20)
- Inappropriate accounting principles (paragraph .21)
- Unreasonable accounting estimates (paragraph .22)

.20 If the auditor concludes that a matter involving an uncertainty is not adequately disclosed in the financial statements in conformity with generally accepted accounting principles, he should qualify his opinion or express an adverse opinion.

.21 In preparing financial statements, management estimates the outcome of certain types of future events. For example, estimates customarily are made about the useful lives of depreciable assets, the collectibility of accounts receivable, the realizable value of inventory items, and the provision for product warranties. SFAS No. 5, paragraphs 23 and 25 [AC section C59.129 and .131], discusses situations in which the inability to make a reasonable estimate may raise questions about the appropriateness of the accounting principles used. If, in those or other situations, the auditor concludes that the accounting principles used cause the financial statements to be materially misstated, he should express a qualified or adverse opinion.

.22 Usually, the auditor is able to satisfy himself regarding the reasonableness of management's estimate of the effects of future events by considering various types of evidential matter, including the historical experience of the entity. If the auditor concludes that management's estimate is unreasonable (see section 312, *Audit Risk and Materiality in Conducting an Audit*, and section 342, *Auditing Accounting Estimates*) and that its effect is to cause the financial statements to be materially misstated, he should express a qualified or an adverse opinion.

Situations Involving Uncertainties That May Require an Explanatory Paragraph

.23 In certain instances, however, the outcome of future events that may affect the financial statements, including required disclosures, is not susceptible of reasonable estimation by management. When such uncertainties exist, it cannot be determined whether the financial statements should be adjusted or in what amount. Such matters are to be regarded as uncertainties for purposes of considering the need for an explanatory paragraph in the auditor's report. In deciding whether to add an explanatory paragraph to the report because of a matter involving an uncertainty (other than a going concern matter), the auditor considers the likelihood of a material loss resulting from the resolution of the uncertainty.

.24 Remote likelihood of a material loss. If management believes and the auditor is satisfied that there is only a remote likelihood of a material loss resulting from resolution of a matter involving an uncertainty, the auditor would not add an explanatory paragraph to his report because of the matter.

.25 Probable chance of material loss. If management believes and the auditor is satisfied that it is probable that a material loss will occur, but management is unable to make a reasonable estimate of the amount or range of potential loss and thus has not made an accrual in the financial statements, the auditor should add an explanatory paragraph to his report because of the matter involving an uncertainty.¹² In some cases, management may, in accordance with generally accepted accounting principles, accrue the estimable portion of a probable loss. In such circumstances, the auditor should decide whether to add an explanatory paragraph to his report by considering the matters described in paragraph .26 with respect to the unrecorded amount of the loss.

.26 Reasonable possibility of a material loss. If management believes and the auditor is satisfied that the chance of a material loss resulting from resolution of a matter involving an uncertainty is more than remote but less than probable, the auditor should consider the following matters in deciding whether to add an explanatory paragraph to his report:

- The magnitude by which the amount of reasonably possible loss exceeds the auditor's judgment about materiality
- The likelihood of occurrence of a material loss (for example, whether that likelihood is closer to remote or to probable)

The auditor is more likely to add an explanatory paragraph to his report as the amount of reasonably possible loss becomes larger or the likelihood of occurrence of a material loss increases.

Materiality Considerations

.27 The auditor should consider materiality in planning the audit and in evaluating whether the financial statements taken as a whole are presented fairly in conformity with generally accepted accounting principles. The auditor evaluates the materiality of reasonably possible losses that may be incurred upon the resolution of the uncertainties both individually and in the aggregate. He performs that evaluation without regard to his evaluation of the materiality of likely error in the financial statements.

.28 The auditor's consideration of materiality is a matter of professional judgment and is influenced by his perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments involving uncertainties are made in light of the surrounding circumstances. Some uncertainties relate primarily to financial position, while others more closely relate to results of operations or cash flows. Thus, for purposes of evaluating the materiality of a possible loss, the auditor should consider which, if any, of the financial statements is the more appropriate base in the circumstances.

.29 Some uncertainties are unusual in nature or infrequent in occurrence and thus more closely related to financial position than to normal, recurring operations (for example, litigation relating to alleged violations of antitrust or securities laws). In such instances, the auditor should consider the possible loss in relation to shareholder's equity and other relevant balance sheet compo-

¹² However, the auditor should consider whether the inability to make an estimate raises questions as to the appropriateness of accounting principles used (see paragraph .21).

nents such as total assets, total liabilities, current assets, and current liabilities.

.30 In other instances, the nature of an uncertainty may be more closely related to normal, recurring operations (for example, litigation with a party to a royalty agreement concerning whether a royalty fee should be paid on certain revenues). In such circumstances, the auditor should consider the possible loss in relation to relevant income statement components, such as income from continuing operations.

Explanatory Paragraph Added to the Report

.31 If, after applying the criteria in paragraphs .24 through .30, the auditor has concluded that he should include an explanatory paragraph (following the opinion paragraph) in his report,¹³ he should describe the matter giving rise to the uncertainty in the explanatory paragraph and indicate that its outcome cannot presently be determined. The separate paragraph(s) may be shortened by referring to disclosures made in a note to the financial statements. However, no reference to the uncertainty should be made in the introductory, scope or opinion paragraphs of his report.¹⁴

.32 An example of an explanatory paragraph (following the opinion paragraph) describing an uncertainty follows:

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counteraction, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

.33 The subsequent resolution of an uncertainty that has led to the addition of an explanatory paragraph to the auditor's report will usually (a) be recognized in the financial statements of a subsequent period, or (b) result in a conclusion that the matter has no material monetary effect on the financial statements of any period. In rare cases, the subsequent resolution may result in adjustment of the financial statements related to the report in which the auditor originally included the explanatory paragraph. However, the paragraph that discusses the uncertainty in the auditor's report should be the same regardless of the accounting treatment expected to be accorded the resolution of the uncertainty.

Lack of Consistency

.34 The auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods because either (a) no change in accounting principles has occurred, or (b) there has been a change in accounting principles or in the method of their application, but the effect of the change on the comparability of the financial statements is not material. In these cases, the auditor should not refer to consistency in his report. If, however, there has been a change in accounting principles or in the method of their application that has a material effect on the comparability of

¹³ Use of the term "subject to" to qualify an opinion because of an uncertainty is no longer permissible under the provisions of this section.

¹⁴ An explanatory paragraph following the opinion paragraph is not necessary when the auditor qualifies his opinion because of a GAAP departure related to an uncertainty and the paragraph that explains the reason for the qualification includes information that would otherwise be required in an explanatory paragraph following the opinion paragraph.

the company's financial statements, the auditor should refer to the change in an explanatory paragraph of his report. Such explanatory paragraph (following the opinion paragraph) should identify the nature of the change and refer the reader to the note in the financial statements that discusses the change in detail. The auditor's concurrence with a change is implicit unless he takes exception to the change in expressing his opinion as to fair presentation of the financial statements in conformity with generally accepted accounting principles.¹⁵ When there is a change in accounting principles, there are also other matters that the auditor should consider (see paragraphs .59 through .66).

.35 Following is an example of an appropriate explanatory paragraph:

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 19X2.

.36 The addition of this explanatory paragraph in the auditor's report is required in reports on financial statements of subsequent years as long as the year of the change is presented and reported on.¹⁶ However, if the accounting change is accounted for by retroactive restatement of the financial statements affected, the additional paragraph is required only in the year of the change since, in subsequent years, all periods presented will be comparable.

Emphasis of a Matter

.37 In some circumstances, the auditor may wish to emphasize a matter regarding the financial statements, but nevertheless intends to express an unqualified opinion. For example, he may wish to emphasize that the entity is a component of a larger business enterprise or that it has had significant transactions with related parties, or he may wish to emphasize an unusually important subsequent event or an accounting matter affecting the comparability of the financial statements with those of the preceding period. Such explanatory information should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type.

Departures From Unqualified Opinions

Qualified Opinions

.38 Certain circumstances may require a qualified opinion. A qualified opinion states that, *except for* the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when—

- a. There is a lack of sufficient competent evidential matter or there are restrictions on the scope of the audit that have led the auditor to conclude that he cannot express an unqualified opinion and he has concluded not to disclaim an opinion (paragraphs .40—.48).
- b. The auditor believes, on the basis of his audit, that the financial statements contain a departure from generally accepted accounting

¹⁵ With respect to the method of accounting for the effect of a change in accounting principle, see Accounting Principles Board Opinion No. 20, *Accounting Changes*, including paragraph 4 [AC section A06.103], which states that methods of accounting for changes in principles resulting from the implementation of new pronouncements is provided in those pronouncements.

¹⁶ An exception to this requirement occurs when a change in accounting principle that does not require a cumulative effect adjustment is made at the beginning of the earliest year presented and reported on. That exception is addressed in the auditing interpretation of section 420, *Consistency of Application of Generally Accepted Accounting Principles*, titled "Impact on the Auditor's Report of FIFO to LIFO Change in Comparative Financial Statements," (section 9420.16—.23).

principles, the effect of which is material, and he has concluded not to express an adverse opinion (paragraphs .49—.66).

.39 When the auditor expresses a qualified opinion, he should disclose all of the substantive reasons in one or more separate explanatory paragraph(s) preceding the opinion paragraph of his report. He should also include, in the opinion paragraph, the appropriate qualifying language and a reference to the explanatory paragraph. A qualified opinion should include the word *except* or *exception* in a phrase such as *except for* or *with the exception of*. Phrases such as *subject to* and *with the foregoing explanation* are not clear or forceful enough and should not be used. Since accompanying notes are part of the financial statements, wording such as *fairly presented, in all material respects, when read in conjunction with Note 1* is likely to be misunderstood and should not be used.

Scope Limitations

.40 The auditor can determine that he is able to express an unqualified opinion only if his audit has been conducted in accordance with generally accepted auditing standards and if he has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of his audit, whether imposed by the client or by circumstances, such as the timing of his work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require him to qualify his opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

.41 The auditor's decision to qualify his opinion or disclaim an opinion because of a scope limitation depends on his assessment of the importance of the omitted procedure(s) to his ability to form an opinion on the financial statements being audited. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved.

.42 Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors.¹⁷ Another common scope restriction involves accounting for long-term investments when the auditor has not been able to obtain audited financial statements of an investee. Restrictions on the application of these or other audit procedures to important elements of the financial statements require the auditor to decide whether he has examined sufficient competent evidential matter to permit him to express an unqualified or qualified opinion, or whether he should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements.

¹⁷ Circumstances such as the timing of his work may make it impossible for the auditor to accomplish these procedures. In this case, if he is able to satisfy himself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of his work, and his report need not include a reference to the omission of the procedures or the use of alternative procedures. It is important to understand, however, that section 331, *Receivables and Inventories*, states that "it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions."

.43 When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of evidential matter, the situation should be described in an explanatory paragraph preceding the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor's report. It is not appropriate for the scope of the audit to be explained in a note to the financial statements, since the description of the audit scope is the responsibility of the auditor and not that of his client.

.44 When an auditor qualifies his opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our audit . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements and, therefore, is unacceptable. An example of a qualified opinion related to a scope limitation concerning an investment in a foreign affiliate (assuming the effects of the limitation are such that the auditor has concluded that a disclaimer of opinion is not appropriate) follows:

Independent Auditor's Report

[Same first paragraph as the standard report]

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at \$_____ and \$_____ at December 31, 19X2 and 19X1, respectively, or its equity in earnings of that affiliate of \$_____ and \$_____, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

.45 Other scope limitations. Sometimes, notes to financial statements may contain unaudited information, such as pro forma calculations or other similar disclosures. If the unaudited information (for example, an investor's share, material in amount, of an investee's earnings recognized on the equity method) is such that it should be subjected to auditing procedures in order for the auditor to form an opinion with respect to the financial statements taken as a whole, the auditor should apply the procedures he deems necessary to the unaudited information. If the auditor has not been able to apply the procedures he considers necessary, he should qualify his opinion or disclaim an opinion because of a limitation on the scope of his audit.

.46 If, however, these disclosures are not necessary to fairly present the financial position, operating results, or cash flows on which the auditor is

reporting, such disclosures may be identified as *unaudited* or as *not covered by the auditor's report*. For example, the pro forma effects of a business combination or of a subsequent event may be labelled unaudited. Therefore, while the event or transaction giving rise to the disclosures in these circumstances should be audited, the pro forma disclosures of that event or transaction would not be. The auditor should be aware, however, that section 530, *Dating of the Independent Auditor's Report*, states that, if the auditor is aware of a material subsequent event that has occurred after the completion of fieldwork but before issuance of the report that should be disclosed, his only options are to dual date the report or date the report as of the date of the subsequent event and extend the procedures for review of subsequent events to that date. Labelling the note unaudited is not an acceptable alternative in these circumstances.

.47 Limited reporting engagements. The auditor may be asked to report on one basic financial statement and not on the others. For example, he may be asked to report on the balance sheet and not on the statements of income, retained earnings or cash flows. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if he applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

.48 An auditor may be asked to report on the balance sheet only. In this case, the auditor may express an opinion on the balance sheet only. An example of an unqualified opinion on a balance-sheet-only audit follows (the report assumes that the auditor has been able to satisfy himself regarding the consistency of application of accounting principles):

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe that our audit of the balance sheet provides a reasonable basis for our opinion.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 19XX, in conformity with generally accepted accounting principles.

Departure From a Generally Accepted Accounting Principle

.49 When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has audited the statements in accordance with generally accepted auditing standards, he should express a qualified (paragraphs .50 through .66) or an adverse (paragraphs .67 through .69) opinion. The basis for such opinion should be stated in his report.

.50 In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or adverse opinion, one factor to be considered is the dollar magni-

tude of such effects. However, the concept of materiality does not depend entirely on relative size; it involves qualitative as well as quantitative judgments. The significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the amounts and presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

.51 When the auditor expresses a qualified opinion, he should disclose, in a separate explanatory paragraph(s) preceding the opinion paragraph of his report, all of the substantive reasons that have led him to conclude that there has been a departure from generally accepted accounting principles. Furthermore, the opinion paragraph of his report should include the appropriate qualifying language and a reference to the explanatory paragraph(s).

.52 The explanatory paragraph(s) should also disclose the principal effects of the subject matter of the qualification on financial position, results of operations, and cash flows, if practicable.¹⁸ If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the explanatory paragraph(s) may be shortened by referring to it.

.53 An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded that an adverse opinion is not appropriate):

Independent Auditor's Report

[Same first and second paragraphs as the standard report]

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$_____ and \$_____, long-term debt by \$_____ and \$_____, and retained earnings by \$_____ and \$_____ as of December 31, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by \$_____ and \$_____ and earnings per share would be increased (decreased) by \$_____ and \$_____, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

.54 If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph (preceding the opinion paragraph) of the auditor's report in the circumstances illustrated in paragraph .53 might read as follows:

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accom-

¹⁸ Section 431, *Adequacy of Disclosure in the Financial Statements*, defines *practicable* as "... the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information." For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in his report.

panying balance sheets. In our opinion, generally accepted accounting principles require that such obligations be included in the balance sheets.

.55 Inadequate disclosure. Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion because of the departure from those principles and should provide the information in his report, if practicable,¹⁹ unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards.

.56 Following is an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

Independent Auditor's Report

[Same first and second paragraphs as the standard report]

The Company's financial statements do not disclose *[describe the nature of the omitted disclosures]*. In our opinion, disclosure of this information is required by generally accepted accounting principles.

In our opinion, except for the omission of the information discussed in the preceding paragraph, . . .

.57 If a company issues financial statements that purport to present financial position and results of operations but omits the related statement of cash flows, the auditor will normally conclude that the omission requires qualification of his opinion.

.58 The auditor is not required to prepare a basic financial statement (for example, a statement of cash flows for one or more periods) and include it in his report if the company's management declines to present the statement. Accordingly, in these cases, the auditor should ordinarily qualify his report in the following manner:

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income and retained earnings for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

[Same second paragraph as the standard report]

The Company declined to present a statement of cash flows for the years ended December 31, 19X2 and 19X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by generally accepted accounting principles.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations for the years then ended in conformity with generally accepted accounting principles.

¹⁹ See footnote 18.

.59 Accounting changes. The auditor should evaluate a change in accounting principle to satisfy himself that (a) the newly adopted accounting principle is a generally accepted accounting principle, (b) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, and (c) management's justification for the change is reasonable. If a change in accounting principle does not meet these conditions, the auditor's report should so indicate, and his opinion should be appropriately qualified as discussed in paragraphs .60 and .61.

.60 If (a) a newly adopted accounting principle is not a generally accepted accounting principle, (b) the method of accounting for the effect of the change is not in conformity with generally accepted accounting principles, or (c) management has not provided reasonable justification for the change in accounting principle, the auditor should express a qualified opinion or, if the effect of the change is sufficiently material, the auditor should express an adverse opinion on the financial statements.

.61 Accounting Principles Board Opinion No. 20, *Accounting Changes*, paragraph 16 [AC section A06.112], states: "The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable." If management has not provided reasonable justification for the change in accounting principles, the auditor should express an exception to the change having been made without reasonable justification. An example of a report qualified for this reason follows:

Independent Auditor's Report

[Same first and second paragraphs as the standard report]

As disclosed in Note X to the financial statements, the Company adopted, in 19X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with generally accepted accounting principles, in our opinion the Company has not provided reasonable justification for making this change as required by generally accepted accounting principles.²⁰

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

.62 Whenever an accounting change results in an auditor expressing a qualified or adverse opinion on the conformity of financial statements with generally accepted accounting principles for the year of change, he should consider the possible effects of that change when reporting on the entity's financial statements for subsequent years, as discussed in paragraph .63 through .66.

²⁰ Section 420, *Consistency of Application of Generally Accepted Accounting Principles*, states that a change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error and that such a change requires recognition in the auditor's report as to consistency. Therefore, the auditor should add an explanatory paragraph to his report discussing the accounting change.

However, because the middle paragraph included in the example presented contains all of the information required in an explanatory paragraph on consistency, a separate explanatory paragraph (following the opinion paragraph) as required by paragraphs .34 through .36 of this section is not necessary in this instance. A separate paragraph that identifies the change in accounting principle would be required if the substance of the disclosure did not fulfill the requirements outlined in these paragraphs.

.63 If the financial statements for the year of such change are presented and reported on with a subsequent year's financial statements, the auditor's report should disclose his reservations with respect to the statements for the year of change.

.64 If an entity has adopted an accounting principle that is not a generally accepted accounting principle, its continued use might have a material effect on the statements of a subsequent year on which the auditor is reporting. In this situation, the independent auditor should express either a qualified opinion or an adverse opinion, depending on the materiality of the departure in relation to the statements of the subsequent year.

.65 If an entity accounts for the effect of a change prospectively when generally accepted accounting principles require restatement or the inclusion of the cumulative effect of the change in the year of change, a subsequent year's financial statements could improperly include a charge or credit that is material to those statements. This situation also requires that the auditor express a qualified or an adverse opinion.

.66 If management has not provided reasonable justification for a change in accounting principles, the auditor's opinion should express an exception to the change having been made without reasonable justification, as previously indicated. In addition, the auditor should continue to express his exception with respect to the financial statements for the year of change as long as they are presented and reported on. However, the auditor's exception relates to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing an exception for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express an exception to use of the newly adopted principle.

Adverse Opinions

.67 An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles.

.68 When the auditor expresses an adverse opinion, he should disclose in a separate explanatory paragraph(s) preceding the opinion paragraph of his report (a) all the substantive reasons for his adverse opinion, and (b) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.²¹ If the effects are not reasonably determinable, the report should so state.²²

.69 When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion, as shown below:

²¹ See footnote 18.

²² When the auditor expresses an adverse opinion, he should also consider the need for an explanatory paragraph under the circumstances identified in paragraph .11, subsections (c), (d), (e), and (f) of this section.

Independent Auditor's Report

[Same first and second paragraphs as the standard report]

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Generally accepted accounting principles require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from generally accepted accounting principles identified above, as of December 31, 19X2 and 19X1, inventories have been increased \$_____ and \$_____ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at \$_____ and \$_____ in excess of an amount based on the cost to the Company; and deferred income taxes of \$_____ and \$_____ have not been recorded; resulting in an increase of \$_____ and \$_____ in retained earnings and in appraisal surplus of \$_____ and \$_____, respectively. For the years ended December 31, 19X2 and 19X1, cost of goods sold has been increased \$_____ and \$_____, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of \$_____ and \$_____ have not been provided, resulting in an increase in net income of \$_____ and \$_____, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19X2 and 19X1, or the results of its operations or its cash flows for the years then ended.

Disclaimer of Opinion

.70 A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. It is appropriate when the auditor has not performed an audit sufficient in scope to enable him to form an opinion on the financial statements.²³ A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his audit, that there are material departures from generally accepted accounting principles (see paragraphs .49 through .66).

.71 When disclaiming an opinion because of a scope limitation, the auditor should indicate in a separate paragraph(s) the reasons why his audit did not comply with generally accepted auditing standards. He should state that the scope of his audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, he should also disclose any other reservations he has regarding fair presentation in conformity with generally accepted accounting principles.

.72 An example of a report disclaiming an opinion resulting from an inability to obtain sufficient competent evidential matter because of the scope limitation follows:

²³ If an accountant is engaged to conduct an audit of the financial statements of a nonpublic entity in accordance with generally accepted auditing standards, but is requested to change the engagement to a review or a compilation of the statements, he should look to guidance in the Statement on Standards for Accounting and Review Services 1, paragraphs 44—49 [AR section 100.44—49]. (See section 504, *Association With Financial Statements*.)

Independent Auditor's Report

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.²⁴

[Second paragraph of standard report should be omitted]

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at \$_____ as of December 31, 19X2, and at \$_____ as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

Piecemeal Opinions

.73 Piecemeal opinions (expressions of opinion as to certain identified items in financial statements) should not be expressed when the auditor has disclaimed an opinion or has expressed an adverse opinion on the financial statements *taken as a whole* because piecemeal opinions tend to overshadow or contradict a disclaimer of opinion or an adverse opinion.

Reports on Comparative Financial Statements

.74 The fourth standard of reporting requires that an auditor's report contain either an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference in the fourth reporting standard to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor²⁵ should update²⁶ his report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of

²⁴ The wording in the first paragraph of the auditor's standard report is changed in a disclaimer of opinion because of a scope limitation. The first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with generally accepted auditing standards. In addition, the last sentence of the first paragraph is also deleted, because of the scope limitation, to eliminate the reference to the auditor's responsibility to express an opinion.

²⁵ A *continuing auditor* is one who has audited the financial statements of the current period and of one or more consecutive periods immediately prior to the current period.

If one firm of independent auditors merges with another firm and the new firm becomes the auditor of a former client of one of the former firms, the new firm may accept responsibility and express an opinion on the financial statements for the prior period(s), as well as for those of the current period. In such circumstances, the new firm should follow the guidance in paragraphs .74 through .78 and may indicate in its report or signature that a merger took place and may name the firm of independent auditors that was merged with it. If the new firm decides not to express an opinion on the prior-period financial statements, the guidance in paragraphs .79 through .83 should be followed.

²⁶ An updated report on prior-period financial statements should be distinguished from a reissuance of a previous report (see section 530, *Dating of the Independent Auditor's Report*, paragraphs .06 through .08), since in issuing an updated report the continuing auditor considers information that he has become aware of during his audit of the current-period financial statements (see paragraph .77) and because an updated report is issued in conjunction with the auditor's report on the current-period financial statements.

the current period.²⁷ Ordinarily, the auditor's report on comparative financial statements should be dated as of the date of completion of his most recent audit. (See section 530, *Dating of the Independent Auditor's Report*, paragraph .01.)

.75 During his audit of the current-period financial statements, the auditor should be alert for circumstances or events that affect the prior-period financial statements presented (see paragraph .77) or the adequacy of informative disclosures concerning those statements. (See section 431, *Adequacy of Disclosure in Financial Statements*, and ARB No. 43, Chapter 2A [AC section F43].) In updating his report on the prior-period financial statements, the auditor should consider the effects of any such circumstances or events coming to his attention.

Different Reports on Comparative Financial Statements Presented

.76 Since the auditor's report on comparative financial statements applies to the individual financial statements presented, an auditor may express a qualified or adverse opinion, disclaim an opinion, or include an explanatory paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements presented. Following are examples of reports on comparative financial statements (excluding the standard introductory and scope paragraphs, where applicable) with different reports on one or more financial statements presented.

Standard Report on the Prior-Year Financial Statements and a Qualified Opinion on the Current-Year Financial Statements

Independent Auditor's Report

[Same first and second paragraphs as the standard report]

The Company has excluded, from property and debt in the accompanying 19X2 balance sheet, certain lease obligations that were entered into in 19X2 which, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$_____, long-term debt by \$_____, and retained earnings by \$_____ as of December 31, 19X2, and net income and earnings per share would be increased (decreased) by \$_____ and \$_____, respectively, for the year then ended.

In our opinion, except for the effects on the 19X2 financial statements of not capitalizing certain lease obligations as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

²⁷ A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units and not-for-profit organizations frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund, or the auditor would need to modify his report.

Standard Report on the Current-Year Financial Statements With a Disclaimer of Opinion on the Prior-Year Statements of Income, Retained Earnings, and Cash Flows

Independent Auditor's Report

[Same first paragraph as the standard report]

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 19X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 19X0, enter into the determination of net income and cash flows for the year ended December 31, 19X1.²⁸

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 19X1.

In our opinion, the balance sheets of ABC Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 19X2, present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the year ended December 31, 19X2, in conformity with generally accepted accounting principles.

Opinion on Prior-Period Financial Statements Different From the Opinion Previously Expressed

.77 If, during his current audit, an auditor becomes aware of circumstances or events that affect the financial statements of a prior period, he should consider such matters when updating his report on the financial statements of the prior period. For example, if an auditor has previously qualified his opinion or expressed an adverse opinion on financial statements of a prior period because of a departure from generally accepted accounting principles, and the prior-period financial statements are restated in the current period to conform with generally accepted accounting principles, the auditor's updated report on the financial statements of the prior period should indicate that the statements have been restated and should express an unqualified opinion with respect to the restated financial statements.

.78 If, in an updated report, the opinion is different from the opinion previously expressed on the financial statements of a prior period, the auditor should disclose all the substantive reasons for the different opinion in a separate explanatory paragraph(s) preceding the opinion paragraph of his report.²⁹ The explanatory paragraph(s) should disclose (a) the date of the

²⁸ It is assumed that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles. See section 420, *Consistency of Application of Generally Accepted Accounting Principles*, for a discussion of consistency.

²⁹ With the elimination of the subject to opinion qualification for uncertainties (see footnote 13), a separate explanatory paragraph (as described above) that discusses the resolution of an

auditor's previous report, (b) the type of opinion previously expressed, (c) the circumstances or events that caused the auditor to express a different opinion, and (d) that the auditor's updated opinion on the financial statements of the prior period is different from his previous opinion on those statements. The following is an example of an explanatory paragraph that may be appropriate when an auditor issues an updated report on the financial statements of a prior period that contains an opinion different from the opinion previously expressed:

Independent Auditor's Report

[Same first and second paragraphs as the standard report]

In our report dated March 1, 19X2, we expressed an opinion that the 19X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 19X1 financial statements to conform with generally accepted accounting principles. Accordingly, our present opinion on the 19X1 financial statements, as presented herein, is different from that expressed in our previous report.³⁰

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Report of Predecessor Auditor

.79 A predecessor auditor ordinarily would be in a position to reissue his report on the financial statements of a prior period at the request of a former client if he is able to make satisfactory arrangements with his former client to perform this service and if he performs the procedures described in paragraph .80.³¹

Predecessor Auditor's Report Reissued

.80 Before reissuing (or consenting to the reuse of) a report previously issued on the financial statements of a prior period, a predecessor auditor should consider whether his previous report on those statements is still appropriate. Either the current form or manner of presentation of the financial statements of the prior period or one or more subsequent events might make a predecessor auditor's previous report inappropriate. Consequently, a predecessor auditor should (a) read the financial statements of the current period, (b) compare the prior-period financial statements that he reported on with the financial statements to be presented for comparative purposes, and (c) obtain a letter of representations from the successor auditor. The letter of representations should state whether the successor's audit revealed any mat-

(Footnote Continued)

uncertainty described in an explanatory paragraph of the previously-issued report is no longer necessary since the latter did not result in a qualified opinion. A separate explanatory paragraph is required only when the current updated opinion is different from the opinion in the immediately preceding report issued.

³⁰ See footnote 20.

³¹ It is recognized that there may be reasons why a predecessor auditor's report may not be reissued and this section does not address the various situations that could arise.

ters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor. Also, the predecessor auditor may wish to consider the matters described in section 543, *Part of Examination Made by Other Independent Auditors*, paragraphs .10 through .12. However, the predecessor auditor should not refer in his reissued report to the report or work of the successor auditor.

.81 A predecessor auditor who has agreed to reissue his report may become aware of events or transactions occurring subsequent to the date of his previous report on the financial statements of a prior period that may affect his previous report (for example, the successor auditor might indicate in his response that certain matters have had a material effect on the prior-period financial statements reported on by the predecessor auditor). In such circumstances, the predecessor auditor should make inquiries and perform other procedures that he considers necessary (for example, reviewing the working papers of the successor auditor as they relate to the matters affecting the prior-period financial statements). He should then decide, on the basis of the evidential matter obtained, whether to revise his report. If a predecessor auditor concludes that his report should be revised, he should follow the guidance in paragraphs .77, .78, and .82 of this section.

.82 A predecessor auditor's knowledge of the current affairs of his former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing his report on prior-period financial statements, a predecessor auditor should use the date of his previous report to avoid any implication that he has examined any records, transactions, or events after that date. If the predecessor auditor revises his report or if the financial statements are restated, he should dual-date his report. (See section 530, *Dating of the Independent Auditor's Report*, paragraph .05.)

Predecessor Auditor's Report Not Presented

.83 If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the introductory paragraph of his report (a) that the financial statements of the prior period were audited by another auditor,³² (b) the date of his report, (c) the type of report issued by the predecessor auditor, and (d) if the report was other than a standard report, the substantive reasons therefor. An example of a successor auditor's report when the predecessor auditor's report is not presented is shown below:

Independent Auditor's Report

We have audited the balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors whose report dated March 31, 19X2, expressed an unqualified opinion on those statements.

[Same second paragraph as the standard report]

In our opinion, the 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

³² The successor auditor should not name the predecessor auditor in his report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with, that of the successor auditor.

If the predecessor auditor's report was other than a standard report, the successor auditor should describe the nature of and reasons for the explanatory paragraph added to the predecessor's report or his opinion qualification. Following is an illustration of the wording that may be included in the successor auditor's report:

... were audited by other auditors whose report dated March 1, 19X2, on those statements included an explanatory paragraph that described the litigation discussed in Note X to the financial statements.

If the financial statements have been restated, the introductory paragraph should indicate that a predecessor auditor reported on the financial statements of the prior period before restatement. In addition, if the successor auditor is able to satisfy himself as to the appropriateness of the restatement, he may also include the following paragraph in his report:

We also reviewed the adjustments described in Note X that were applied to restate the 19X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

Effective Date and Transition

.84 This section is effective for reports issued or reissued on or after January 1, 1989. Earlier application of the provisions of this section is permissible.

.85 An auditor who expressed an opinion qualified *subject to* the effect of an uncertainty on prior-period financial statements should consider the status of the uncertainty in determining his reporting responsibilities under the reporting provisions of this section. If the uncertainty has been resolved in the current period, no mention of the uncertainty (or of the opinion qualification of the prior-period financial statements) is required in the auditor's report.³³ If, however, the uncertainty still exists in the current period, the auditor should include an explanatory paragraph in his report because of the uncertainty as discussed in paragraphs .31 through .33.

[The next page is 771.]

³³ The auditor should, however, consider the adequacy of the disclosure regarding the resolution of the uncertainty in the company's financial statements.

AU Section 530

Dating of the Independent Auditor's Report

Sources: SAS No. 1, section 530; SAS No. 29.

Issue date, unless otherwise indicated: November, 1972.

.01 Generally, the date of completion of the field work should be used as the date of the independent auditor's report. Paragraph .05 describes the procedure to be followed when a subsequent event occurring after the completion of the field work is disclosed in the financial statements.

.02 The auditor has no responsibility to make any inquiry or carry out any auditing procedures for the period after the date of his report.¹ However, with respect to filings under the Securities Act of 1933, reference should be made to section 711.10—.13.*

Events Occurring After Completion of Field Work But Before Issuance of Report

.03 In case a subsequent event of the type requiring adjustment of the financial statements (as discussed in section 560.03) occurs after the date of the independent auditor's report but before its issuance, and the event comes to the attention of the auditor, the financial statements should be adjusted or the auditor should qualify his opinion.² When the adjustment is made without disclosure of the event, the report ordinarily should be dated in accordance with paragraph .01. However, if the financial statements are adjusted and disclosure of the event is made, or if no adjustment is made and the auditor qualifies his opinion,³ the procedures set forth in paragraph .05 should be followed.

.04 In case a subsequent event of the type requiring disclosure (as discussed in section 560.05) occurs after the date of the auditor's report but before issuance of his report, and the event comes to the attention of the auditor, it should be disclosed in a note to the financial statements or the auditor should qualify his opinion.⁴ If disclosure of the event is made, either in a note or in the auditor's report, the auditor would date his report as set forth in the following paragraph.

.05 The independent auditor has two methods available for dating his report when a subsequent event disclosed in the financial statements occurs after completion of his field work but before issuance of his report. He may use "dual dating," for example, "February 16, 19 , except for Note , as to which the date is March 1, 19 ," or he may date his report as of the later

¹ See section 561 regarding procedures to be followed by the auditor who, subsequent to the date of his report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected his report had he then been aware of such facts.

* Reference changed by issuance of Statement on Auditing Standards No. 37.

² In some cases, a disclaimer of opinion or an adverse opinion may be appropriate.

³ Ibid.

⁴ Ibid.

date. In the former instance, his responsibility for events occurring subsequent to the completion of his field work is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the date of his report and, accordingly, the procedures outlined in section 560.12 generally should be extended to that date.

Reissuance of the Independent Auditor's Report

.06 An independent auditor may reissue his report on financial statements contained in annual reports filed with the Securities and Exchange Commission or other regulatory agencies or in a document he submits to his client or to others that contains information in addition to the client's basic financial statements subsequent to the date of his original report on the basic financial statements. An independent auditor may also be requested by his client to furnish additional copies of a previously issued report. Use of the original report date in a reissued report removes any implication that records, transactions, or events after that date have been examined or reviewed. In such cases, the independent auditor has no responsibility to make further investigation or inquiry as to events which may have occurred during the period between the original report date and the date of the release of additional reports. However, see section 711 * as to an auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933. [As modified, effective December 31, 1980, by SAS No. 29.] (See section 551.)

.07 In some cases, it may not be desirable for the independent auditor to reissue his report in the circumstances described in paragraph .06 because he has become aware of an event that occurred subsequent to the date of his original report that requires adjustment or disclosure in the financial statements. In such cases, adjustment with disclosure or disclosure alone should be made as described in section 560.08. The independent auditor should consider the effect of these matters on his opinion and he should date his report in accordance with the procedures described in paragraph .05.

.08 However, if an event of the type requiring disclosure only (as discussed in sections 560.05 and 560.08) occurs between the date of the independent auditor's original report and the date of the reissuance of such report, and if the event comes to the attention of the independent auditor, the event may be disclosed in a separate note to the financial statements captioned somewhat as follows:

Event (Unaudited) Subsequent to the Date of the
Report of Independent Auditor.

Under these circumstances, the report of the independent auditor would carry the same date used in the original report.

[The next page is 801.]

* Reference changed by issuance of Statement on Auditing Standards No. 37.

AU Section 534***Reporting on Financial
Statements Prepared for
Use in Other Countries***

Source: SAS No. 51.

Effective for examinations of financial statements for periods beginning after July 31, 1986, unless otherwise indicated.

.01 This section provides guidance for an independent auditor practicing in the United States who is engaged to report on the financial statements of a U.S. entity that have been prepared in conformity with accounting principles generally accepted in another country for use outside the United States.¹ A "U.S. entity" is an entity that is either organized or domiciled in the United States.

Purpose and Use of Financial Statements

.02 A U.S. entity ordinarily prepares financial statements for use in the United States in conformity with accounting principles generally accepted in the United States, but it may also prepare financial statements that are intended for use outside the United States and are prepared in conformity with accounting principles generally accepted in another country. For example, the financial statements of a U.S. entity may be prepared for inclusion in the consolidated financial statements of a non-U.S. parent. A U.S. entity may also have non-U.S. investors or may decide to raise capital in another country. Before reporting on financial statements prepared in conformity with the accounting principles of another country, the auditor should have a clear understanding of, and obtain written representations from management regarding, the purpose and uses of such financial statements. If the auditor uses the standard report of another country, and the financial statements will have general distribution in that country, he should consider whether any additional legal responsibilities are involved.

General and Fieldwork Standards

.03 When examining the financial statements of a U.S. entity prepared in conformity with accounting principles generally accepted in another country, the auditor should perform the procedures that are necessary to comply with the general and fieldwork standards of U.S. generally accepted auditing standards (GAAS).

.04 The auditing procedures generally performed under U.S. GAAS may need to be modified, however. The assertions embodied in financial statements prepared in conformity with accounting principles generally accepted in another country may differ from those prepared in conformity with U.S.

¹ See paragraph .07, however, for a discussion of financial statements prepared in conformity with accounting principles generally accepted in another country for limited distribution in the United States.

generally accepted accounting principles. For example, accounting principles generally accepted in another country may require that certain assets be revalued to adjust for the effects of inflation—in which case, the auditor should perform procedures to test the revaluation adjustments. On the other hand, another country's accounting principles may not require or permit recognition of deferred taxes; consequently, procedures for testing deferred tax balances would not be applicable. As another example, the accounting principles of some countries do not require or permit disclosure of related party transactions. Determining that such transactions are properly disclosed, therefore, would not be an audit objective in such cases. Other objectives, however, would remain relevant—such as identifying related parties in order to fully understand the business purpose, nature, and extent of the transactions and their effects on the financial statements.

.05 The auditor should understand the accounting principles generally accepted in the other country. Such knowledge may be obtained by reading the statutes or professional literature (or codifications thereof) that establish or describe the accounting principles generally accepted in the other country. Application of accounting principles to a particular situation often requires practical experience; the auditor should consider, therefore, consulting with persons having such expertise in the accounting principles of the other country. If the accounting principles of another country are not established with sufficient authority or by general acceptance, or a broad range of practices is acceptable, the auditor may nevertheless be able to report on financial statements for use in such countries if, in the auditor's judgment, the client's principles and practices are appropriate in the circumstances and are disclosed in a clear and comprehensive manner. In determining the appropriateness of the accounting principles used, the auditor may consider, for example, International Accounting Standards established by the International Accounting Standards Committee.

Compliance With Auditing Standards of Another Country

.06 In those circumstances in which the auditor is requested to apply the auditing standards of another country when reporting on financial statements prepared in conformity with accounting principles generally accepted in that country, the auditor should comply with the general and fieldwork standards of that country as well as with those standards in U.S. GAAS. This may require the auditor to perform certain procedures required by auditing standards of the other country in addition to those required by U.S. GAAS. The auditor will need to read the statutes or professional literature, or codifications thereof, that establish or describe the auditing standards generally accepted in the other country. He should understand, however, that such statutes or professional literature may not be a complete description of auditing practices and, therefore, should consider consulting with persons having expertise in the auditing standards of the other country.

Reporting Standards

.07 If financial statements prepared in conformity with accounting principles generally accepted in another country are prepared for use only outside the United States, the auditor may report using either (a) a U.S.-style report modified to report on the accounting principles of another country (see paragraphs .09 and .10) or (b) if appropriate, the report form of the other country (see paragraphs .11 and .12). This is not intended to preclude limited distribution of the financial statements to parties (such as banks, institutional

investors, and other knowledgeable parties that may choose to rely on the report) within the United States that deal directly with the entity, if the financial statements are to be used in a manner that permits such parties to discuss differences from U.S. accounting and reporting practices and their significance with the entity.

.08 Financial statements prepared in conformity with accounting principles generally accepted in another country ordinarily are not useful to U.S. users. Therefore, if financial statements are needed for use both in another country and within the United States, the auditor may report on two sets of financial statements for the entity—one prepared in conformity with accounting principles generally accepted in another country for use outside the United States, and the other prepared in accordance with accounting principles generally accepted in the United States (see paragraph .13). If dual statements are not prepared, or for some other reason the financial statements prepared in conformity with accounting principles generally accepted in another country will have more than limited distribution in the United States, the auditor should report on them using the U.S. standard form of report, modified as appropriate for departures from accounting principles generally accepted in the United States (see paragraph .14).

Use Only Outside the United States

.09 A U.S.-style report modified to report on financial statements prepared in conformity with accounting principles generally accepted in another country that are intended for use only outside the United States should—

- a. Identify the financial statements examined.
- b. Refer to the note to the financial statements that describes the basis of presentation of the financial statements on which the auditor is reporting, including identification of the nationality of the accounting principles.
- c. State that the examination was made in accordance with auditing standards generally accepted in the United States (and, if appropriate, with the auditing standards of the other country).
- d. Include a paragraph that expresses the auditor's opinion (or disclaims an opinion) on the following:
 - (1) Whether the financial statements are presented fairly in conformity with the basis of accounting described. If the auditor concludes that the financial statements are not presented fairly on the basis of accounting described, all of the substantive reasons for that conclusion should be disclosed in an additional explanatory paragraph(s) of the report, and the opinion paragraph should include appropriate modifying language as well as a reference to the explanatory paragraph(s).
 - (2) Whether the disclosed basis of accounting used has been applied in a consistent manner.

.10 The following is an illustration of such a report.

We have examined the balance sheet of the International Company as of December 31, 19XX, and the related statements of income, retained earnings, and changes in financial position for the year then ended, which, as described in Note X, have been prepared on the basis of accounting principles generally accepted in [name of country]. Our examination was made in accordance with auditing standards generally accepted in the United States (and in [name of country]) and, accordingly, included such tests of the

accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of the International Company at December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with accounting principles generally accepted in [name of country] applied on a basis consistent with that of the preceding year.

.11 The independent auditor may also use the auditor's standard report of another country, provided that—

- a. Such a report would be used by auditors in the other country in similar circumstances.
- b. The auditor understands, and is in a position to make, the attestations contained in such a report (see paragraph .12).

The auditor should consider whether the standard report of another country or the financial statements may be misunderstood because they resemble those prepared in conformity with U.S. standards. When the auditor believes there is a risk of misunderstanding, he should identify the other country in the report.

.12 When the auditor uses the standard report of the other country, the auditor should comply with the reporting standards of that country. The auditor should recognize that the standard report used in another country, even when it appears similar to that used in the United States, may convey a different meaning and entail a different responsibility on the part of the auditor due to custom or culture. Use of a standard report of another country may also require the auditor to provide explicit or implicit assurance of statutory compliance or otherwise require understanding of local law. When using the auditor's standard report of another country, the auditor needs to understand applicable legal responsibilities, in addition to the auditing standards and the accounting principles generally accepted in the other country. Accordingly, depending on the nature and extent of the auditor's knowledge and experience, he should consider consulting with persons having expertise in the audit reporting practices of the other country to attain the understanding needed to issue that country's standard report.

.13 A U.S. entity that prepares financial statements in conformity with U.S. generally accepted accounting principles also may prepare financial statements in conformity with accounting principles generally accepted in another country for use outside the United States. In such circumstances, the auditor may report on the financial statements that are in conformity with accounting principles of the other country by following the guidance in paragraphs .09 and .10. The auditor may wish to include, in one or both of the reports, a statement that another report has been issued on the financial statements for the entity that have been prepared in accordance with accounting principles generally accepted in another country. The auditor may also wish to reference any note describing significant differences between the accounting principles used and U.S. GAAP. An example of such a statement follows.

We also have reported separately on the financial statements of International Company for the same period presented in accordance with accounting principles generally accepted in [name of country]. (The significant differences between the accounting principles accepted in [name of country] and those generally accepted in the United States are summarized in Note X.)

Use in the United States

.14 If the auditor is requested to report on the fair presentation of financial statements, prepared in conformity with the accounting principles generally accepted in another country, that will have more than limited distribution in the United States, he should use the U.S. standard form of report (see section 509, *Reports on Audited Financial Statements*, paragraph .07, in Appendix G), modified as appropriate (see section 509.15—.17 in Appendix G), because of departures from accounting principles generally accepted in the United States.² The auditor may also, in a separate paragraph to the report, express an opinion on whether the financial statements are presented in conformity with accounting principles generally accepted in another country.

.15 The auditor may also report on the same set of financial statements, prepared in conformity with accounting principles generally accepted in another country, that will have more than limited distribution in the United States by using both the standard report of the other country or a U.S.-style report (described in paragraph .09) for distribution outside the United States, and a U.S. form of report (described in paragraph .14) for distribution in the United States.

Effective Date

.16 This section is effective for examinations of financial statements for periods beginning after July 31, 1986.

[The next page is 841.]

² This section does not apply to reports on financial statements of U.S. subsidiaries of foreign registrants presented in SEC filings of foreign parent companies where the subsidiaries' financial statements have been prepared on the basis of accounting principles used by the parent company.

AU Section 543***Part of Examination
Made by Other Inde-
pendent Auditors***

Source: SAS No. 1, section 543.

See section 9543 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 This section provides guidance on the professional judgments the independent auditor makes in deciding (a) whether he may serve as principal auditor and use the work and reports of other independent auditors who have examined the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented and (b) the form and content of the principal auditor's report in these circumstances.¹ Nothing in this section should be construed to require or imply that an auditor, in deciding whether he may properly serve as principal auditor without himself auditing particular subsidiaries, divisions, branches, components, or investments of his client, should make that decision on any basis other than his judgment regarding the professional considerations as discussed in paragraphs .02 and .10; nor should an auditor state or imply that a report that makes reference to another auditor is inferior in professional standing to a report without such a reference. [As modified, September 1981, by the Auditing Standards Board.]

Principal Auditor's Course of Action

.02 The auditor considering whether he may serve as principal auditor may have performed all but a relatively minor portion of the work, or significant parts of the examination may have been performed by other auditors. In the latter case, he must decide whether his own participation is sufficient to enable him to serve as the principal auditor and to report as such on the financial statements. In deciding this question, the auditor should consider, among other things, the materiality of the portion of the financial statements he has examined in comparison with the portion examined by other auditors, the extent of his knowledge of the overall financial statements, and the importance of the components he examined in relation to the enterprise as a whole. [As modified, September 1981, by the Auditing Standards Board.]

.03 If the auditor decides that it is appropriate for him to serve as the principal auditor, he must then decide whether to make reference in his report² to the examination made by another auditor. If the principal auditor decides to assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the

¹ Section 315 applies if an auditor uses the work of a predecessor auditor in expressing an opinion on financial statements.

² See paragraph .09 for example of appropriate reporting when reference is made to the examination of other auditors.

financial statements taken as a whole, no reference should be made to the other auditor's examination. On the other hand, if the principal auditor decides not to assume that responsibility, his report should make reference to the examination of the other auditor and should indicate clearly the division of responsibility between himself and the other auditor in expressing his opinion on the financial statements. Regardless of the principal auditor's decision, the other auditor remains responsible for the performance of his own work and for his own report.

Decision Not to Make Reference

.04 If the principal auditor is able to satisfy himself as to the independence and professional reputation of the other auditor (see paragraph .10) and takes steps he considers appropriate to satisfy himself as to the other auditor's examination (see paragraph .12), he may be able to express an opinion on the financial statements taken as a whole without making reference in his report to the examination of the other auditor. If the principal auditor decides to take this position, he should not state in his report that part of the examination was made by another auditor because to do so may cause a reader to misinterpret the degree of responsibility being assumed.

.05 Ordinarily, the principal auditor would be able to adopt this position when:

- a. Part of the examination is made by another independent auditor which is an associated or correspondent firm and whose work is acceptable to the principal auditor based on his knowledge of the professional standards and competence of that firm; or
- b. The other auditor was retained by the principal auditor and the work was performed under the principal auditor's guidance and control; or
- c. The principal auditor, whether or not he selected the other auditor, nevertheless takes steps he considers necessary to satisfy himself as to the other auditor's examination and accordingly is satisfied as to the reasonableness of the accounts for the purpose of inclusion in the financial statements on which he is expressing his opinion; or
- d. The portion of the financial statements examined by the other auditor is not material to the financial statements covered by the principal auditor's opinion.

Decision to Make Reference

.06 On the other hand, the principal auditor may decide to make reference to the examination of the other auditor when he expresses his opinion on the financial statements. In some situations, it may be impracticable for the

principal auditor to review the other auditor's work or to use other procedures which in the judgment of the principal auditor would be necessary for him to satisfy himself as to the other auditor's examination. Also, if the financial statements of a component examined by another auditor are material in relation to the total, the principal auditor may decide, regardless of any other considerations, to make reference in his report to the examination of the other auditor.

.07 When the principal auditor decides that he will make reference to the examination of the other auditor, his report should indicate clearly, in both the scope and opinion paragraphs, the division of responsibility as between that portion of the financial statements covered by his own examination and that covered by the examination of the other auditor. The report should disclose the magnitude of the portion of the financial statements examined by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly reveals the portion of the financial statements examined by the other auditor. The other auditor may be named but only with his express permission and provided his report is presented together with that of the principal auditor.³

.08 Reference in the report of the principal auditor to the fact that part of the examination was made by another auditor is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors who conducted the examinations of various components of the overall financial statements. [As modified, September 1981, by the Auditing Standards Board.]

.09 An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the examination of the other auditor follows:

We have examined the consolidated balance sheet of X Company and subsidiaries as of December 31, 19....., and the related consolidated statements of income and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of B Company, a consolidated subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. These statements were examined by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for B Company is based solely upon the report of the other auditors.

³ As to filings with the Securities and Exchange Commission, see Rule 2-05 of Regulation S-X.

In our opinion, based upon our examination and the report of other auditors, the accompanying consolidated balance sheet and consolidated statements of income and retained earnings and changes in financial position present fairly . . .

When two or more auditors in addition to the principal auditor participate in the examination, the percentages covered by the other auditors may be stated in the aggregate.

Procedures Applicable to Both Methods of Reporting

.10 Whether or not the principal auditor decides to make reference to the examination of the other auditor, he should make inquiries concerning the professional reputation and independence of the other auditor. He also should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements. These inquiries and other measures may include procedures such as the following:

- a. Make inquiries as to the professional reputation and standing of the other auditor to one or more of the following:
 - (i) The American Institute of Certified Public Accountants,⁴ the applicable state society of certified public accountants and/or the local chapter, or in the case of a foreign auditor, his corresponding professional organization.
 - (ii) Other practitioners.
 - (iii) Bankers and other credit grantors.
 - (iv) Other appropriate sources.
- b. Obtain a representation from the other auditor that he is independent under the requirements of the American Institute of Certified Public Accountants and, if appropriate, the requirements of the Securities and Exchange Commission.
- c. Ascertain through communication with the other auditor:
 - (i) That he is aware that the financial statements of the component which he is to examine are to be included in the financial statements on which the principal auditor will report and that the

⁴The AICPA Professional Ethics Division can respond to inquiries about whether individuals are members of the American Institute of Certified Public Accountants and whether complaints against members have been adjudicated by the Trial Board or the National Review Board. The division cannot respond to inquiries about public accounting firms or provide information about administrative reprimands issued by the division or pending disciplinary proceedings or investigations. The AICPA Division for CPA Firms can respond to inquiries about whether specific public accounting firms are members of either the Private Companies Practice Section (PCPS) or the SEC Practice Section (SECPS), and can indicate whether a firm has undergone peer review in compliance with the Section's membership requirements and whether any sanctions against the firm have been publicly announced. In addition, the division will supply, for a fee, copies of peer-review reports that have been accepted by the applicable section of the division and information submitted by member firms on applications for membership and annual updates.

other auditor's report thereon will be relied upon (and, where applicable, referred to) by the principal auditor.

- (ii) That he is familiar with accounting principles generally accepted in the United States and with the generally accepted auditing standards promulgated by the American Institute of Certified Public Accountants and will conduct his examination and will report in accordance therewith.
- (iii) That he has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with regulatory agencies such as the Securities and Exchange Commission, if appropriate.
- (iv) That a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.

(Inquiries as to matters under a, and c (ii) and (iii) ordinarily would be unnecessary if the principal auditor already knows the professional reputation and standing of the other auditor and if the other auditor's primary place of practice is in the United States.)

[As modified, September 1981, by the Auditing Standards Board.]

.11 If the results of inquiries and procedures by the principal auditor with respect to matters described in paragraph .10 lead him to the conclusion that he can neither assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, nor report in the manner set forth in paragraph .09, he should appropriately qualify his opinion or disclaim an opinion on the financial statements taken as a whole. His reasons therefor should be stated, and the magnitude of the portion of the financial statements to which his qualification extends should be disclosed.

Additional Procedures Under Decision Not to Make Reference

.12 When the principal auditor decides not to make reference to the examination of the other auditor, in addition to satisfying himself as to the matters described in paragraph .10, he should also consider whether to perform one or more of the following procedures:

- a. Visit the other auditor and discuss the audit procedures followed and results thereof.
- b. Review the audit programs of the other auditor. In some cases, it may be appropriate to issue instructions to the other auditor as to the scope of his audit work.
- c. Review the working papers of the other auditor, including his evaluation of internal control and his conclusions as to other significant aspects of the engagement.

.13 In some circumstances the principal auditor may consider it appropriate to participate in discussions regarding the accounts with management personnel of the component whose financial statements are being examined by other auditors and/or to make supplemental tests of such accounts. The determination of the extent of additional procedures, if any, to be applied rests with the principal auditor alone in the exercise of his professional judgment and in no way constitutes a reflection on the adequacy of the other auditor's work. Because the principal auditor in this case assumes responsibility for his opinion on the financial statements on which he is reporting without making reference to the other auditor's examination, his judgment must govern as to the extent of procedures to be undertaken.

Long-Term Investments

.14 With respect to investments accounted for under the equity method, the auditor who uses another auditor's report for the purpose of reporting on the investor's equity in underlying net assets and its share of earnings or losses and other transactions of the investee is in the position of a principal auditor using the work and reports of other auditors. Under these circumstances, the auditor may decide that it would be appropriate to refer to the other auditor's examination in his report on the financial statements of the investor. (See paragraphs .06—.11.) When the work and reports of other auditors constitute a major element of evidence with respect to investments accounted for under the cost method, the auditor may be in a position analogous to that of a principal auditor.

Qualifications in Other Auditor's Report

.15 If the opinion of the other auditor is qualified, the principal auditor should decide whether the subject of the qualification is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require qualification of his own report. If the subject of the qualification is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to the qualification; if the other auditor's report is presented, the principal auditor may wish to make reference to such qualification and its disposition.

Restated Financial Statements of Prior Years Following a Pooling of Interests

.16 Following a pooling-of-interests transaction, an auditor may be asked to report on restated financial statements for one or more prior years when other auditors have examined one or more of the entities included in such financial statements. In some of these situations the auditor may decide that he has not examined a sufficient portion of the financial statements for such prior year or years to enable him to serve as principal auditor (see paragraph .02). Also, in such cases, it often is not possible or it may not be appropriate or necessary for the auditor to satisfy himself with respect to the restated

financial statements. In these circumstances it may be appropriate for him to express his opinion solely with respect to the combining of such statements; however, no opinion should be expressed unless the auditor has examined the statements of at least one of the entities included in the restatement for at least the latest period presented. The following is an illustration of appropriate reporting on such combination that can be presented in an additional paragraph of the auditor's report following the standard scope and opinion paragraphs covering the consolidated financial statements for the current year:*

We previously examined and reported upon the consolidated statements of income and changes in financial position of XYZ Company and subsidiaries for the year ended December 31, 19X1, prior to their restatement for the 19X2 pooling of interests. The contribution of XYZ Company and subsidiaries to revenues and net income represented percent and percent of the respective restated totals. Separate financial statements of the other companies included in the 19X1 restated consolidated statements of income and changes in financial position were examined and reported upon separately by other auditors. We also have applied procedures to the combination of the accompanying consolidated statements of income and changes in financial position for the year ended December 31, 19X1, after restatement for the 19X2 pooling of interests; in our opinion, such consolidated statements have been properly combined on the basis described in Note A of notes to consolidated financial statements.

[As modified, October 1980, by the Auditing Standards Board.]

.17 In reporting on restated financial statements as described in the preceding paragraph, the auditor does not assume responsibility for the work of other auditors nor the responsibility for expressing an opinion on the restated financial statements taken as a whole. He should apply procedures which will enable him to express an opinion only as to proper combination of the financial statements. These procedures include testing the combination for clerical accuracy and the methods used to combine the restated financial statements for conformity with generally accepted accounting principles. For example, the auditor should make inquiries and apply procedures regarding such matters as the following:

- a. Elimination of intercompany transactions and accounts.
- b. Combining adjustments and reclassifications.
- c. Adjustments to treat like items in a comparable manner, if appropriate.
- d. The manner and extent of presentation of disclosure matters in the restated financial statements and notes thereto.

The auditor should also consider the application of procedures contained in paragraph .10.

[As modified, October 1980, by the Auditing Standards Board.]

* If restated consolidated balance sheets are also presented, the auditor may also express his opinion with respect to the combination of the consolidated balance sheets.

Predecessor Auditor

[.18] [Superseded by Statement on Auditing Standards No. 7, effective November 30, 1975.] (See section 315.)

→*The next page is 861.*←

AU Section 544

Lack of Conformity With Generally Accepted Accounting Principles

Sources: SAS No. 1, section 544; SAS No. 2; SAS No. 14.

See section 9544 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

[.01] [Superseded by Statement on Auditing Standards No. 2, effective December 31, 1974.] (See section 509 in Appendix G.)

Regulated Companies

.02 The basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (Such companies include public utilities, common carriers, insurance companies, financial institutions, and the like.) Accordingly, the first reporting standard is equally applicable to opinions on financial statements of such regulated companies presented for purposes other than filings with their respective supervisory agencies; and material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated.¹ Ordinarily, this will require either a qualified or an adverse opinion on such statements. An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles. [As amended, effective for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2.] (See section 509 in Appendix G.) [As amended by Statement on Auditing Standards No. 14, effective with respect to engagements to issue special reports on data for periods beginning after December 31, 1976.] (See section 621.)

.03 It should be recognized, however, that appropriate differences exist with respect to the application of generally accepted accounting principles as between regulated and nonregulated businesses because of the effect in regulated businesses of the rate-making process, a phenomenon not present in nonregulated businesses. Such differences usually concern mainly the time at which various items enter into the determination of net income in accordance

¹ When reporting on financial statements of a regulated company that are prepared in accordance with the requirements of financial reporting provisions of a government regulatory agency to whose jurisdiction the company is subject, the auditor may report on the financial statements as being prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles (see section 621.02—.08, *Special Reports*). Reports of this nature, however, should be issued only if the financial statements are intended solely for filing with the regulatory agency or if additional distribution is recognized as appropriate by an AICPA accounting or audit guide or auditing interpretation.

with the principle of matching costs and revenues. It should also be recognized that accounting requirements not directly related to the rate-making process commonly are imposed on regulated businesses and that the imposition of such accounting requirements does not necessarily mean that they conform with generally accepted accounting principles.

.04 When financial statements of a regulated company are prepared in accordance with a basis of accounting prescribed by its supervisory agency or the financial reporting provisions of another agency, the independent auditor may also be requested to report on their fair presentation in conformity with such prescribed basis of accounting in presentations other than filings with the company's regulatory agency. In those circumstances, except when such reporting is recognized as appropriate by an AICPA accounting or audit guide or auditing interpretation, the auditor should use the standard form of report (see section 509.07, *Reports on Audited Financial Statements, in Appendix G*), modified as appropriate (see section 509.15—.17 in Appendix G) because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting. [As amended by Statement on Auditing Standards No. 14, effective with respect to engagements to issue special reports on data for periods beginning after December 31, 1976.] (See section 621.)

[The next page is 911.]

AU Section 550

Other Information in Documents Containing Audited Financial Statements

Source: SAS No. 8.

See section 9550 for interpretations of this section.

Issue date, unless otherwise indicated: December, 1975.

.01 An entity may publish various documents that contain information (hereinafter, "other information") in addition to audited financial statements and the independent auditor's report thereon. This section provides guidance for the auditor's consideration of other information included in such documents.

.02 This section is applicable only to other information contained in (a) annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Securities Exchange Act of 1934 or (b) other documents to which the auditor, at the client's request, devotes attention.

.03 This section is not applicable when the financial statements and report appear in a registration statement filed under the Securities Act of 1933. The auditor's procedures with respect to 1933 Act filings are unaltered by this section (see sections 634[†] and 711^{††}). Also, this section is not applicable to other information on which the auditor is engaged to express an opinion.¹ The guidance applicable to examining and reporting on certain information other than financial statements intended to be presented in conformity with generally accepted accounting principles is unaltered by this section (see sections 551^{*} and 621^{**}).

.04 Other information in a document may be relevant to an independent auditor's examination or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is

[†] [Reference number 631, formerly 630, changed by the issuance of Statement on Auditing Standards No. 38 (superseded). Reference number 634, formerly 631, changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

^{††} [Reference changed by issuance of Statement on Auditing Standards No. 37.] (See section 711.)

¹ Mere reading of other information is an inadequate basis for expressing an opinion on that information.

^{*} [Reference changed by issuance of Statement on Auditing Standards No. 29.] (See section 551.)

^{**} [Reference changed by issuance of Statement on Auditing Standards No. 14.] (See section 621.)

materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.² If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision. If he concludes that they do not require revision, he should request the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, he should consider other actions such as revising his report to include an explanatory paragraph describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement. The action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

.05 If, while reading the other information for the reasons set forth in paragraph .04, the auditor becomes aware of information that he believes is a material misstatement of fact that is not a material inconsistency as described in paragraph .04, he should discuss the matter with the client. In connection with this discussion, the auditor should consider that he may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion. If the auditor concludes he has a valid basis for concern he should propose that the client consult with some other party whose advice might be useful to the client, such as the client's legal counsel.

.06 If, after discussing the matter as described in paragraph .05, the auditor concludes that a material misstatement of fact remains, the action he takes will depend on his judgment in the particular circumstances. He should consider steps such as notifying his client in writing of his views concerning the information and consulting his legal counsel as to further appropriate action in the circumstances.

[The next page is 915.]

² In fulfilling his responsibility under this section, a principal auditor may also request the other auditor or auditors involved in the engagement to read the other information. If a predecessor auditor's report appears in a document to which this section applies, he should read the other information for the reasons described in this paragraph.

AU Section 551

Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents

(Supersedes section 610, "Long-Form Reports")¹

Source: SAS No. 29.

Effective for auditors' reports dated on or after December 31, 1980, unless otherwise indicated.

.01 This section provides guidance on the form and content of reporting when an auditor submits to his client or to others a document that contains information in addition to the client's basic financial statements and the auditor's standard report thereon.

.02 The auditor's standard report covers the basic financial statements: balance sheet, statement of income, statement of retained earnings or changes in stockholders' equity, and statement of changes in financial position. The following presentations are considered part of the basic financial statements: descriptions of accounting policies, notes to financial statements, and schedules and explanatory material that are identified as being part of the basic financial statements. For purposes of this section, basic financial statements also include an individual basic financial statement, such as a balance sheet or statement of income and financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.

.03 The information covered by this section is presented outside the basic financial statements and is not considered necessary for presentation of financial position, results of operations, or changes in financial position in conformity with generally accepted accounting principles. Such information includes additional details or explanations of items in or related to the basic financial statements, consolidating information, historical summaries of items extracted from the basic financial statements, statistical data, and other material, some of which may be from sources outside the accounting system or outside the entity.

¹ This section also supersedes the March 1979 auditing interpretation, "Reports on Consolidated Financial Statements That Include Supplementary Consolidating Information" (AU section 9509.15—20).

Reporting Responsibility

.04 When an auditor submits a document containing audited financial statements to his client or to others, he has a responsibility to report on all the information included in the document. On the other hand, when the auditor's standard report is included in a client-prepared document² and the auditor is not engaged to report on information accompanying the basic financial statements, his responsibility with respect to such information is described in (a) section 550, *Other Information in Documents Containing Audited Financial Statements*, and (b) other sections covering particular types of information or circumstances, such as section 553, *Supplementary Information Required by the Financial Accounting Standards Board*.

.05 An auditor's report on information accompanying the basic financial statements in an auditor-submitted document has the same objective as an auditor's report on the basic financial statements: to describe clearly the character of the auditor's examination and the degree of responsibility, if any, he is taking. Although the auditor may participate in the preparation of the accompanying information as well as the basic financial statements, both the statements and the accompanying information are representations of management.

.06 The following guidelines apply to an auditor's report on information accompanying the basic financial statements in an auditor-submitted document:

- a. The report should state that the examination has been made for the purpose of forming an opinion on the basic financial statements taken as a whole.
- b. The report should identify the accompanying information. (Identification may be by descriptive title or page number of the document.)
- c. The report should state that the accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements.³
- d. The report should include either an opinion on whether the accompanying information is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to the auditing procedures applied in the examination of the basic financial statements. The auditor may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.
- e. The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

.07 The purpose of an examination of basic financial statements in accordance with generally accepted auditing standards is to form an opinion on those statements taken as a whole. Nevertheless, an examination of basic financial statements often encompasses information accompanying those statements in an auditor-submitted document. Also, although an auditor has no obligation to apply auditing procedures to information presented outside

² Client-prepared documents include financial reports prepared by the client but merely reproduced by the auditor on the client's behalf.

³ The auditor may refer to any regulatory agency requirements applicable to the information presented.

the basic financial statements, he may choose to modify or redirect certain of the procedures to be applied in the examination of the basic financial statements so that he may express an opinion on the accompanying information in the manner described in paragraph .06.

.08 When reporting in this manner, the measurement of materiality is the same as that used in forming an opinion on the basic financial statements taken as a whole. Accordingly, the auditor need not apply procedures as extensive as would be necessary to express an opinion on the information taken by itself. Guidance applicable to the expression of an opinion on specified elements, accounts, or items of financial statements for the purpose of a separate presentation is provided in section 621.10—.14, *Special Reports*.

.09 If the auditor concludes, on the basis of facts known to him, that any accompanying information is materially misstated in relation to the basic financial statements taken as a whole, he should discuss the matter with the client and propose appropriate revision of the accompanying information.⁴ If the client will not agree to revision of the accompanying information, the auditor should either modify his report on the accompanying information and describe the misstatement or refuse to include the information in the document.

.10 The auditor should consider the effect of any modifications in his standard report when reporting on accompanying information. When the auditor expresses a qualified opinion on the basic financial statements, he should make clear the effects upon any accompanying information as well (see paragraph .14). When the auditor expresses an adverse opinion, or disclaims an opinion, on the basic financial statements, he should not express the opinion described in paragraph .06 on any accompanying information.⁵ An expression of such an opinion in these circumstances would be inappropriate because, like a piecemeal opinion, it may tend to overshadow or contradict the disclaimer of opinion or adverse opinion on the basic financial statements. (See section 509.48 [in Appendix G] and section 621.12.)

.11 A client may request that nonaccounting information and certain accounting information not directly related to the basic financial statements be included in an auditor-submitted document. Ordinarily, such information would not have been subjected to the auditing procedures applied in the examination of the basic financial statements, and, accordingly, the auditor would disclaim an opinion on it. In some circumstances, however, such information may have been obtained or derived from accounting records that have been tested by the auditor (for example, number of units produced related to royalties under a license agreement or number of employees related to a given payroll period). Accordingly, the auditor may be in a position to express an opinion on such information in the manner described in paragraph .06.

Reporting Examples

.12 An example of reporting on information accompanying the basic financial statements in an auditor-submitted document follows:

⁴ See paragraph .10 for guidance when there is a modification of the auditor's standard report on the basic financial statements.

⁵ The provisions of this paragraph do not change the guidance, concerning companies whose accounting practices are prescribed by governmental regulatory authorities or commissions, in the last sentence of section 544.02, "Regulated Companies," which reads: "An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles."

Our examination was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the examination of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.⁶

.13 When the auditor disclaims an opinion on all or part of the accompanying information in a document that he submits to his client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances. Two examples follow.

Disclaimer on All of the Information

Our examination was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify the accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the examination of the basic financial statements, and, accordingly, we express no opinion on it.

Disclaimer on Part of the Information

Our examination was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX—YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the examination of the basic financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

.14 An example follows of reporting on accompanying information to which a qualification in the auditor's report on the basic financial statements applies.

Our examination was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedules of investments (page 7), property (page 8), and other assets (page 9) as of December 31, 19XX, are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information in such schedules has been subjected to the auditing procedures applied in the examination of the basic financial statements; and, in our opinion, except for the effects on the schedule of investments of not accounting for the investments in certain companies by the equity method as explained in the second preceding paragraph [second paragraph of our report on page 1], such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Supplementary Information Required by FASB or GASB Pronouncements

.15 When supplementary information required by the FASB or GASB is presented outside the basic financial statements in an auditor-submitted document, the auditor should disclaim an opinion on the information unless he

⁶ This form of reporting is not appropriate with respect to supplementary information required by the FASB (see paragraph .15).

has been engaged to examine and express an opinion on it.⁷ The following is an example of a disclaimer an auditor might use in these circumstances:

The [identify the supplementary information] on page XX is not a required part of the basic financial statements but is supplementary information required by the (Financial or Governmental) Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Also, the auditor's report should be expanded in accordance with section 558, *Required Supplementary Information*, paragraph .08, if (a) supplementary information that the FASB or GASB requires to be presented in the circumstances is omitted, (b) the auditor has concluded that the measurement or presentation of the supplementary information departs materially from guidelines prescribed by the FASB or GASB, (c) the auditor is unable to complete the procedures prescribed by section 558, or (d) the auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines. [As amended, April 1988, by Statement on Auditing Standards No. 58.]

Consolidating Information

.16 Consolidated financial statements may include consolidating information or consolidating schedules presenting separate financial statements of one or more components of the consolidated group.⁸ In some cases, the auditor is engaged to express an opinion on the financial statements of the components as well as on the consolidated financial statements. In other cases, the auditor is engaged to express an opinion only on the consolidated financial statements but consolidating information or schedules accompany the basic consolidated financial statements.

.17 When the auditor is engaged to express an opinion only on the consolidated financial statements and consolidating information is also included, the auditor should be satisfied that the consolidating information is suitably identified. For example, when the consolidated financial statements include columns of information about the components of the consolidated group, the balance sheets might be titled, "Consolidated Balance Sheet—December 31, 19X1, with Consolidated Information," and the columns including the consolidating information might be marked, "Consolidating Information." When the consolidating information is presented in separate schedules, the schedules presenting balance sheet information of the components might be titled, for example, "Consolidating Schedule, Balance Sheet Information, December 31, 19X1."

.18 When the consolidated financial statements include consolidating information that has not been separately examined, the auditor's report on the consolidating information might read

⁷ The guidance in subsection (b) of this paragraph applies to GASB required supplementary information, such as that required by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*. The auditor should refer to section 552, *Reporting on Condensed Financial Statements and Selected Financial Data*, paragraphs .09—.10, for an example of a report on GASB required supplementary information.

⁸ This section [paragraphs .16—.19] is also applicable to combined and combining financial statements.

Our examination was made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and changes in financial position of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the examination of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

.19 When the auditor is engaged to express an opinion on both the consolidated financial statements and the separate financial statements of the components presented in consolidating financial statements, the auditor's reporting responsibilities with respect to the separate financial statements are the same as his responsibilities with respect to the consolidated financial statements. In such cases, the consolidating financial statements and accompanying notes should include all the disclosures that would be necessary for presentation in conformity with generally accepted accounting principles of separate financial statements of each component.

Additional Commentary Concerning the Audit

.20 The auditor may be requested to describe the procedures applied to specific items in the financial statements. Additional comments of this nature should not contradict or detract from the description of the scope of his examination in the standard report. Also, they should be set forth separately rather than interspersed with the information accompanying the basic financial statements to maintain a clear distinction between management's representations and the auditor's representations.

Co-existing Financial Statements

.21 More than one type of document containing the audited financial statements may exist. For example, the auditor may submit to his client or others a document containing the basic financial statements, other information, and his report thereon, and the client may issue a separate document containing only the basic financial statements and the auditor's standard report. The basic financial statements should include all the information considered necessary for presentation in conformity with generally accepted accounting principles in all co-existing documents. The auditor should be satisfied that information accompanying the basic financial statements in an auditor-submitted document would not support a contention that the basic financial statements in the other document were not presented in conformity with generally accepted accounting principles because of inadequate disclosure of material information known to the auditor.

Effective Date

.22 This section will be effective for auditors' reports dated on or after December 31, 1980.

AU Section 552

Reporting on Condensed Financial Statements and Selected Financial Data

Source: SAS No. 42.

Effective for accountants' reports, dated on or after September 30, 1982, on condensed financial statements or selected financial data unless otherwise indicated.

.01 This section provides guidance on reporting in a client-prepared document on—

- a. Condensed financial statements (either for an annual or an interim period) that are derived from audited financial statements of a public entity¹ that is required to file, at least annually, complete audited financial statements with a regulatory agency.
- b. Selected financial data that are derived from audited financial statements of either a public or a nonpublic entity and that are presented in a document that includes audited financial statements (or, with respect to a public entity, that incorporates audited financial statements by reference to information filed with a regulatory agency).

Guidance on reporting on condensed financial statements or selected financial data that accompany audited financial statements in an auditor-submitted document is provided in section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*.

.02 In reporting on condensed financial statements or selected financial data in circumstances other than those described in paragraph .01, the auditor should follow the guidance in section 509, *Reports on Audited Financial Statements*, paragraph .17 [see Appendix G] (see paragraph .07 and footnote 6 of this section), section 621, *Special Reports*, or other applicable Statements on Auditing Standards.²

Condensed Financial Statements

.03 Condensed financial statements are presented in considerably less detail than complete financial statements that are intended to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. For this reason, they should be read in conjunction with the entity's most recent complete financial

¹ Public entity is defined in section 504, *Association With Financial Statements*, footnote 2.

² An auditor who has examined and reported on complete financial statements of a nonpublic entity may subsequently be requested to compile financial statements for the same period that omit substantially all disclosures required by generally accepted accounting principles. Reporting on comparative financial statements in those circumstances is described in SSARS 2, paragraphs 29—30 [AR section 200.29—30].

statements that include all the disclosures required by generally accepted accounting principles.

.04 An auditor may be engaged to report on condensed financial statements that are derived from audited financial statements. Because condensed financial statements do not constitute a fair presentation of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles, an auditor should not report on condensed financial statements in the same manner as he reported on the complete financial statements from which they are derived. To do so might lead users to assume, erroneously, that the condensed financial statements include all the disclosures necessary for complete financial statements. For the same reason, it is desirable that the condensed financial statements be so marked.

.05 In the circumstances described in paragraph .01(a),³ the auditor's report on condensed financial statements that are derived from financial statements that he has audited should indicate (a) that the auditor has examined and expressed an opinion on the complete financial statements, (b) the date of the auditor's report on the complete financial statements,⁴ (c) the type of opinion expressed, and (d) whether, in the auditor's opinion, the information set forth in the condensed financial statements is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.⁵

.06 The following is an example of wording that an auditor may use in the circumstances described in paragraph .01(a) to report on condensed financial statements that are derived from financial statements that he has audited and on which he has expressed an unqualified opinion:

We have examined, in accordance with generally accepted auditing standards, the consolidated balance sheet of X Company and subsidiaries as of December 31, 19X0, and the related consolidated statements of income, retained earnings, and changes in financial position for the year then ended (not presented herein); and in our report dated February 15, 19X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated in all material respects in relation to the consolidated financial statements from which it has been derived.

.07 A client might make a statement in a client-prepared document that names the auditor and also states that condensed financial statements have

³ SEC regulations require certain registrants to include in filings, as a supplementary schedule to the consolidated financial statements, condensed financial information of the parent company. The auditor should report on such condensed financial information in the same manner as he reports on other supplementary schedules.

⁴ Reference to the date of the original report removes any implication that records, transactions, or events after that date have been examined. The auditor does not have a responsibility to investigate or inquire further into events that may have occurred during the period between the date of the report on the complete financial statements and the date of the report on the condensed financial statements. (However, see section 711 regarding the auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933.)

⁵ If the auditor's opinion on the complete financial statements was other than unqualified, the report should describe the nature of, and the reasons for, the qualification. Also, if the auditor's opinion on the complete financial statements referred to another auditor, the report on the condensed financial statements should state that fact. However, no reference to consistency is necessary if a change in accounting referred to in the auditor's report on the complete financial statements does not affect the comparability of the information being presented. The auditor should consider the effect that any modification of the opinion on the complete financial statements might have on the opinion on the condensed financial statements or selected financial data.

been derived from audited financial statements. Such a statement does not, in itself, require the auditor to report on the condensed financial statements, provided that they are included in a document that contains audited financial statements (or that incorporates such statements by reference to information filed with a regulatory agency). However, if such a statement is made in a client-prepared document of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency and that document does not include audited financial statements (or does not incorporate such statements by reference to information filed with a regulatory agency),⁶ the auditor should request that the client either (a) not include the auditor's name in the document or (b) include the auditor's report on the condensed financial statements, as described in paragraph .05. If the client will neither delete the reference to the auditor nor allow the appropriate report to be included, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate.⁷

.08 Condensed financial statements derived from audited financial statements of a public entity may be presented on a comparative basis with interim financial information as of a subsequent date that is accompanied by the auditor's review report. In that case, the auditor should report on the condensed financial statements of each period in a manner appropriate for the type of service provided for each period. The following is an example of a review report on a condensed balance sheet as of March 31, 19X1, and the related condensed statements of income and changes in financial position for the three-month periods ended March 31, 19X1 and 19X0, together with a report on a condensed balance sheet derived from audited financial statements as of December 31, 19X0, included in Form 10-Q:⁸

⁶ If such a statement is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency, at least annually, the auditor would ordinarily express an adverse opinion on the condensed financial statements because of inadequate disclosure. (See section 509.17 in Appendix G.) The auditor would not be expected to provide the disclosure in his report. The following is an example of an auditor's report on condensed financial statements in such circumstances when the auditor had previously examined and reported on the complete financial statements:

We have examined the consolidated balance sheet of X Company and subsidiaries as of December 31, 19X0, and the related consolidated statements of income, retained earnings, and changes in financial position for the year then ended (not presented herein). Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The condensed consolidated balance sheet as of December 31, 19X0, and the related condensed consolidated statements of income, retained earnings, and changes in financial position for the year then ended, presented on pages xx—xx, are presented as a summary and therefore do not include all of the disclosures required by generally accepted accounting principles.

In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company and subsidiaries as of December 31, 19X0, or the results of their operations and changes in their financial position for the year then ended.

⁷ In considering what other actions, if any, may be appropriate in these circumstances, the auditor may wish to consult his legal counsel.

⁸ Regulation S-X specifies that the following financial information should be provided in filings on Form 10-Q:

a. An interim balance sheet as of the end of the most recent fiscal quarter and a balance sheet (which may be condensed to the same extent as the interim balance sheet) as of the end of the preceding fiscal year.

b. Interim condensed statements of income for the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year.

We have made a review of the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 19X1, and the related condensed consolidated statements of income and changes in financial position for the three-month periods ended March 31, 19X1 and 19X0, in accordance with standards established by the American Institute of Certified Public Accountants.

A review of interim financial information consists principally of obtaining an understanding of the system for the preparation of interim financial information, applying analytical review procedures to financial data, and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with generally accepted accounting principles.

We have previously examined, in accordance with generally accepted auditing standards, the consolidated balance sheet as of December 31, 19X0, and the related consolidated statements of income, retained earnings, and changes in financial position for the year then ended (not presented herein); and in our report dated February 15, 19X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 19X0, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

Selected Financial Data

.09 An auditor may be engaged to report on selected financial data that are included in a client-prepared document that contains audited financial statements (or, with respect to a public entity, that incorporates such statements by reference to information filed with a regulatory agency). Selected financial data are not a required part of the basic financial statements, and the entity's management is responsible for determining the specific selected financial data to be presented.⁹ If the auditor is engaged to report on the selected financial data, his report should be limited to data that are derived from audited financial statements (which may include data that are calculated from amounts presented in the financial statements, such as working capital). If the selected financial data that management presents include both data derived from audited financial statements and other information (such as number of employees or square footage of facilities), the auditor's report should specifically identify the data on which he is reporting. The report should indicate (a) that the auditor has examined and expressed an opinion on

(Footnote Continued)

c. Interim condensed statements of changes in financial position for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter and for the corresponding period of the preceding fiscal year.

This financial information need not be audited, and, accordingly, there is no requirement for an auditor to report on condensed financial statements contained in Form 10-Q. If the auditor has made a review of interim financial information, however, he may agree to the reference to his name and the inclusion of his review report in a Form 10-Q. (See section 722, *Review of Interim Financial Information*, paragraph 23.)

⁹ Under regulations of the SEC, certain reports must include, for each of the last five fiscal years, selected financial data in accordance with regulation S-K, including net sales or operating revenues, income or loss from continuing operations, income or loss from continuing operations per common share, total assets, long-term obligations and redeemable preferred stock and cash dividends declared per common share. Registrants may include additional items that they believe may be useful. There is no SEC requirement for the auditor to report on selected financial data.

the complete financial statements, (b) the type of opinion expressed,¹⁰ and (c) whether, in the auditor's opinion, the information set forth in the selected financial data is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.¹¹ If the selected financial data for any of the years presented are derived from financial statements that were examined by another independent auditor, the report on the selected financial data should state that fact, and the auditor should not express an opinion on that data.

.10 The following is an example of an auditor's report that includes an additional paragraph because he is also engaged to report on selected financial data for a five-year period ended December 31, 19X5, in a client-prepared document that includes audited financial statements:

We have examined the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and changes in financial position for each of the three years in the period ended December 31, 19X5. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of the ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 19X5, in conformity with generally accepted accounting principles applied on a consistent basis.

We have also previously examined, in accordance with generally accepted auditing standards, the consolidated balance sheets as of December 31, 19X3, 19X2, and 19X1, and the related consolidated statements of income, retained earnings, and changes in financial position for the years ended December 31, 19X2 and 19X1 (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 19X5, appearing on page xx, is fairly stated in all material respects in relation to the consolidated financial statements from which it has been derived.

.11 In introductory material regarding the selected financial data included in a client-prepared document, an entity might name the independent auditor and state that the data are derived from financial statements that he examined. Such a statement does not, in itself, require the auditor to report on the selected financial data, provided that the selected financial data are presented in a document that contains audited financial statements (or, with respect to a public entity, that incorporates such statements by reference to information filed with a regulatory agency). If such a statement is made in a document that does not include (or incorporate by reference) audited financial statements, the auditor should request that neither his name nor reference to him be associated with the information, or he should disclaim an opinion on the selected financial data and request that the disclaimer be included in the document. If the client does not comply, the auditor should advise the client that he does not consent to either the use of his name or the

¹⁰ See footnote 5.

¹¹ Nothing in this section is intended to preclude an auditor from expressing an opinion on one or more specified elements, accounts, or items of a financial statement, providing the provisions of section 621.10—.14, are observed.

reference to him, and he should consider what other actions might be appropriate.¹²

Effective Date

.12 This section is effective for accountants' reports dated on or after September 30, 1982, on condensed financial statements or selected financial data.

[The next page is 925.]

¹² See footnote 7.

AU Section 558

Required Supplementary Information

(Supersedes section 553)*

Source: SAS No. 52.

Issue date, unless otherwise indicated: April, 1988.

.01 The Financial Accounting Standards Board (FASB) and Governmental Accounting Standards Board (GASB) develop standards for financial reporting, including standards for financial statements and for certain other information supplementary to financial statements.¹ This section provides the independent auditor with guidance on the nature of procedures to be applied to supplementary information required by the FASB or GASB, and describes the circumstances that would require the auditor to report such information.

* This section also withdraws the following Statements on Auditing Standards:

- Statement on Auditing Standards No. 28, *Supplementary Information on the Effects of Changing Prices* [Formerly section 554].
 - Statement on Auditing Standards No. 40, *Supplementary Mineral Reserve Information* [Formerly section 556].
 - Statement on Auditing Standards No. 45, *Supplementary Oil and Gas Reserve Information* [Formerly section 557].
- SAS No. 45 will be reissued as an auditing interpretation.

¹ The FASB and GASB's roles in setting standards for financial reporting have been recognized by the AICPA Council. The FASB's authority to establish standards for disclosure of financial information outside of the basic financial statements is described in the following resolution:

That as of (September 19, 1987), the FASB, in respect of statements of financial accounting standards finally adopted by such board in accordance with its rules of procedure and the bylaws of the Financial Accounting Foundation, be, and hereby is, designated by this Council as the body to establish accounting principles pursuant to rule 203 and standards on disclosure of financial information for such entities outside financial statements in published financial reports containing financial statements under rule 202 of the *Rules of the Code of Professional Conduct* of the American Institute of Certified Public Accountants provided, however, any accounting research bulletins, or opinions of the accounting principles board issued or approved for exposure by the accounting principles board prior to April 1, 1973, and finally adopted by such board on or before June 30, 1973, shall constitute statements of accounting principles promulgated by a body designated by Council as contemplated in rule 203 of the *Rules of the Code of Professional Conduct* unless and until such time as they are expressly superseded by action of the FASB.

The GASB's authority to establish standards for financial reporting is described in the following resolution:

That as of (September 19, 1987), the GASB, with respect to statements of governmental accounting standards adopted and issued in July 1984 and subsequently in accordance with its rules of procedure and the bylaws of the FASB, be, and hereby is, designated by the Council of the American Institute of Certified Public Accountants as the body to establish financial accounting principles for state and local governmental entities pursuant to rule 203, and standards on disclosure of financial information for such entities outside financial statements in published financial reports containing financial statements under rule 202.

Applicability

.02 This section is applicable in an audit in accordance with generally accepted auditing standards of financial statements included in a document that should contain supplementary information required by the FASB or GASB. However, this section is not applicable if the auditor has been engaged to audit such supplementary information.²

.03 Some entities may voluntarily include, in documents containing audited financial statements, certain supplementary information that is required of other entities. When an entity voluntarily includes such information as a supplement to the financial statements or in an unaudited note to the financial statements, the provisions of this section are applicable unless either the entity indicates that the auditor has not applied the procedures described in this section or the auditor includes in an explanatory paragraph in his report on the audited financial statements a disclaimer on the information.³ The following is an example of a disclaimer an auditor might use in these circumstances:

The [*identify the supplementary information*] on page XX (or in Note XX) is not a required part of the basic financial statements, and we did not audit or apply limited procedures to such information and do not express any assurances on such information.

When the auditor does not apply the procedures described in this section to a voluntary presentation of required supplementary information required for other entities, the provisions of section 550, apply.

Involvement With Information Outside Financial Statements

.04 The objective of an audit of financial statements in accordance with generally accepted auditing standards is the expression of an opinion on such statements. The auditor has no responsibility to audit information outside the basic financial statements in accordance with generally accepted auditing standards. However, the auditor does have certain responsibilities with respect to information outside the financial statements. The nature of the auditor's responsibility varies with the nature of both the information and the document containing the financial statements.

.05 The auditor's responsibility for other information not required by the FASB or GASB but included in certain annual reports—which are client-prepared documents⁴—is specified in section 550. The auditor's responsibility for information outside the basic financial statements in documents that the auditor submits to the client or to others is specified in section 551. The auditor's responsibility for supplementary information required by the FASB or GASB (called *required supplementary information*) is discussed in the paragraphs that follow.

² This section is not applicable to entities that voluntarily present supplementary information not required by the FASB or GASB. For example, entities that voluntarily present supplementary information on the effects of inflation and changes in specific prices, formerly required by FASB Statement No. 33, *Financial Reporting and Changing Prices*, are guided by section 550, *Other Information in Documents Containing Audited Financial Statements*.

³ When supplementary information is presented in an auditor-submitted document outside the basic financial statements, the guidance in section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as amended by SAS 58, *Omnibus Statement on Auditing Standards—1987*, should be followed.

⁴ Client-prepared documents include financial reports prepared by the client but merely reproduced by the auditor on the client's behalf.

Involvement With Required Supplementary Information

.06 Required supplementary information differs from other types of information outside the basic financial statements because the FASB or GASB considers the information an essential part of the financial reporting of certain entities and because authoritative guidelines for the measurement and presentation of the information have been established. Accordingly, the auditor should apply certain limited procedures to required supplementary information and should report deficiencies in, or the omission of, such information.

Procedures

.07 The auditor should consider whether supplementary information is required by the FASB or GASB in the circumstances. If supplementary information is required, the auditor ordinarily should apply the following procedures to the information.⁵

- a. Inquire of management about the methods of preparing the information, including (1) whether it is measured and presented within prescribed guidelines, (2) whether methods of measurement or presentation have been changed from those used in the prior period and the reasons for any such changes, and (3) any significant assumptions or interpretations underlying the measurement or presentation.
- b. Compare the information for consistency with (1) management's responses to the foregoing inquiries, (2) audited financial statements,⁶ and (3) other knowledge obtained during the examination of the financial statements.
- c. Consider whether representations on required supplementary information should be included in specific written representations obtained from management (section 333, *Client Representations*).
- d. Apply additional procedures, if any, that other statements, interpretations, guides, or statements of position prescribe for specific types of required supplementary information.
- e. Make additional inquiries if application of the foregoing procedures causes the auditor to believe that the information may not be measured or presented within applicable guidelines.

Circumstances Requiring Reporting on Required Supplementary Information

.08 Since the supplementary information is not audited and is not a required part of the basic financial statements, the auditor need not add an explanatory paragraph to his report on the audited financial statements to refer to the supplementary information or to his limited procedures, except in

⁵ These procedures are also appropriate when the auditor is involved with voluntary presentations of such information required for other entities (see paragraph .03).

⁶ GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*, requires presentation of certain 10-year historical trend information relating to pension activities as supplementary information outside the basic financial statements. Such information is generally derived from financial statements. If such required supplementary information has been derived from audited financial statements and is presented outside the basic financial statements in an auditor-submitted document, the auditor may report on this information as indicated in section 552, *Reporting on Condensed Financial Statements and Selected Financial Data*, paragraph .10.

any of the following circumstances:⁷ (a) the supplementary information that the FASB or GASB requires to be presented in the circumstances is omitted; (b) the auditor has concluded that the measurement or presentation of the supplementary information departs materially from prescribed guidelines; (c) the auditor is unable to complete the prescribed procedures; (d) the auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines. Since the required supplementary information does not change the standards of financial accounting and reporting used for the preparation of the entity's basic financial statements, the circumstances described above do not affect the auditor's opinion on the fairness of presentation of such financial statements in conformity with generally accepted accounting principles. Furthermore, the auditor need not present the supplementary information if it is omitted by the entity. The following are examples of additional explanatory paragraphs an auditor might use in these circumstances.

Omission of Required Supplementary Information

The (Company or Governmental Unit) has not presented [*describe the supplementary information required by the FASB or GASB in the circumstances*] that the (Financial or Governmental) Accounting Standards Board has determined is necessary to supplement, although not required to be part of, the basic financial statements.

Material Departures From Guidelines

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As a result of such limited procedures, we believe that the [*specifically identify the supplementary information*] is not in conformity with guidelines established by the (Financial or Governmental) Accounting Standards Board because [*describe the material departure(s) from the FASB or GASB guidelines*].

Prescribed Procedures Not Completed

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

Unresolved Doubts About Adherence to Guidelines

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by the (Financial or Governmental) Accounting Standards Board. [*The auditor should consider including in his report the reason(s) he was unable to resolve his substantial doubts.*]

Even though he is unable to complete the prescribed procedures, if, on the basis of facts known to him, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines,

⁷ When required supplementary information is presented outside the basic financial statements in an auditor-submitted document, the auditor should disclaim an opinion on the information unless he has been engaged to examine and express an opinion on it (see section 551.15).

he should suggest appropriate revision; failing that, he should describe the nature of any material departure(s) in his report.

.09 If the entity includes with the supplementary information an indication that the auditor performed any procedures regarding the information without also indicating that the auditor does not express an opinion on the information presented, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the information.

.10 Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the FASB or GASB. However, management may choose not to place the required supplementary information outside the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information.

[The next page is 941.]

AU Section 560

Subsequent Events

Sources: SAS No. 1, section 560; SAS No. 12.

Issue date, unless otherwise indicated: November, 1972.

.01 An independent auditor's report ordinarily is issued in connection with historical financial statements that purport to present financial position at a stated date and results of operations and changes in financial position for a period ended on that date. However, events or transactions sometimes occur subsequent to the balance-sheet date, but prior to the issuance of the financial statements and auditor's report, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements. These occurrences hereinafter are referred to as "subsequent events."

.02 Two types of subsequent events require consideration by management and evaluation by the independent auditor.

.03 The first type consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.

.04 Identifying events that require adjustment of the financial statements under the criteria stated above calls for the exercise of judgment and knowledge of the facts and circumstances. For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy subsequent to the balance-sheet date would be indicative of conditions existing at the balance-sheet date, thereby calling for adjustment of the financial statements before their issuance. On the other hand, a similar loss resulting from a customer's major casualty such as a fire or flood subsequent to the balance-sheet date would not be indicative of conditions existing at the balance-sheet date and adjustment of the financial statements would not be appropriate. The settlement of litigation for an amount different from the liability recorded in the accounts would require adjustment of the financial statements if the events, such as personal injury or patent infringement, that gave rise to the litigation had taken place prior to the balance-sheet date.

.05 The second type consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements.¹ Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading. Occasionally such an event may be so significant that disclosure can best be made by supplementing the

¹ This paragraph is not intended to preclude giving effect in the balance sheet, with appropriate disclosure, to stock dividends or stock splits or reverse splits consummated after the balance-sheet date but before issuance of the financial statements.

historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements.

.06 Examples of events of the second type that require disclosure to the financial statements (but should not result in adjustment) are:

- a. Sale of a bond or capital stock issue.
- b. Purchase of a business.
- c. Settlement of litigation when the event giving rise to the claim took place subsequent to the balance-sheet date.
- d. Loss of plant or inventories as a result of fire or flood.
- e. Losses on receivables resulting from conditions (such as a customer's major casualty) arising subsequent to the balance-sheet date.

.07 Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities ordinarily will require adjustment of the financial statements (see paragraph .03) because such events typically represent the culmination of conditions that existed over a relatively long period of time. Subsequent events such as changes in the quoted market prices of securities ordinarily should not result in adjustment of the financial statements (see paragraph .05) because such changes typically reflect a concurrent evaluation of new conditions.

.08 When financial statements are reissued, for example, in reports filed with the Securities and Exchange Commission or other regulatory agencies, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. Events occurring between the time of original issuance and reissuance of financial statements should not result in adjustment of the financial statements² unless the adjustment meets the criteria for the correction of an error or the criteria for prior period adjustments set forth in Opinions of the Accounting Principles Board.* Similarly, financial statements reissued in comparative form with financial statements of subsequent periods should not be adjusted for events occurring subsequent to the original issuance unless the adjustment meets the criteria stated above.

² However, see paragraph .05 as to the desirability of presenting pro forma financial statements to supplement the historical financial statements in certain circumstances.

* See also Statement of Financial Accounting Standards No. 16, *Prior Period Adjustments* (AC section A35).

.09 Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his report an explanatory paragraph directing the reader's attention to the event and its effects. (See section 545.03 in Appendix G.)

Auditing Procedures in the Subsequent Period

.10 There is a period after the balance-sheet date with which the auditor must be concerned in completing various phases of his examination. This period is known as the "subsequent period" and is considered to extend to the date of the auditor's report. Its duration will depend upon the practical requirements of each examination and may vary from a relatively short period to one of several months. Also, all auditing procedures are not carried out at the same time and some phases of an examination will be performed during the subsequent period, whereas other phases will be substantially completed on or before the balance-sheet date. As an audit approaches completion, the auditor will be concentrating on the unresolved auditing and reporting matters and he is not expected to be conducting a continuing review of those matters to which he has previously applied auditing procedures and reached satisfaction.

.11 Certain specific procedures are applied to transactions occurring after the balance-sheet date such as (a) the examination of data to assure that proper cutoffs have been made and (b) the examination of data which provide information to aid the auditor in his evaluation of the assets and liabilities as of the balance-sheet date.

.12 In addition, the independent auditor should perform other auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles. These procedures should be performed at or near the completion of the field work. The auditor generally should:

- a. Read the latest available interim financial statements; compare them with the financial statements being reported upon; and make any other comparisons considered appropriate in the circumstances. In order to make these procedures as meaningful as possible for the purpose expressed above, the auditor should inquire of officers and other executives having responsibility for financial and accounting matters as to whether the interim statements have been prepared on the same basis as that used for the statements under examination.
- b. Inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:
 - (i) Whether any substantial contingent liabilities or commitments existed at the date of the balance sheet being reported on or at the date of inquiry.
 - (ii) Whether there was any significant change in the capital stock, long-term debt, or working capital to the date of inquiry.
 - (iii) The current status of items, in the financial statements being reported on, that were accounted for on the basis of tentative, preliminary, or inconclusive data.

- (iv) Whether any unusual adjustments had been made during the period from the balance-sheet date to the date of inquiry.
 - c. Read the available minutes of meetings of stockholders, directors, and appropriate committees; as to meetings for which minutes are not available, inquire about matters dealt with at such meetings.
 - d. Inquire of client's legal counsel concerning litigation, claims, and assessments. [As amended, January 1976, by Statement on Auditing Standards No. 12.] (See section 337.)
 - e. Obtain a letter of representations, dated as of the date of the auditor's report, from appropriate officials, generally the chief executive officer and chief financial officer, as to whether any events occurred subsequent to the date of the financial statements being reported on by the independent auditor that in the officer's opinion would require adjustment or disclosure in these statements. The auditor may elect to have the client include representations as to significant matters disclosed to the auditor in his performance of the procedures in subparagraphs (a) to (d) above and (f) below.
 - f. Make such additional inquiries or perform such procedures as he considers necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures, inquiries, and discussions.
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[The next page is 951.]

AU Section 561***Subsequent Discovery of
Facts Existing at the Date
of the Auditor's Report***

Source: SAS No. 1, section 561.

Issue date, unless otherwise indicated: November, 1972.

.01 The procedures described in this section should be followed by the auditor who, subsequent to the date of his report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected his report had he then been aware of such facts.

.02 Because of the variety of conditions which might be encountered, some of these procedures are necessarily set out only in general terms; the specific actions to be taken in a particular case may vary somewhat in the light of the circumstances. The auditor would be well advised to consult with his attorney when he encounters the circumstances to which this section may apply because of legal implications that may be involved in actions contemplated herein, including, for example, the possible effect of state statutes regarding confidentiality of auditor-client communications.

.03 After he has issued his report, the auditor has no obligation ¹ to make any further or continuing inquiry or perform any other auditing procedures with respect to the audited financial statements covered by that report, unless new information which may affect his report comes to his attention. In addition, this section does not apply to situations arising from developments or events occurring after the date of the auditor's report; neither does it apply to situations where, after issuance of the auditor's report, final determinations or resolutions are made of contingencies or other matters which had been disclosed in the financial statements or which had resulted in a qualification in the auditor's report.

.04 When the auditor becomes aware of information which relates to financial statements previously reported on by him, but which was not known to him at the date of his report, and which is of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his examination, he should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of his report. In this connection, the auditor should discuss the matter with his client at whatever management levels he deems appropriate, including the board of directors, and request cooperation in whatever investigation may be necessary.

.05 When the subsequently discovered information is found both to be reliable and to have existed at the date of the auditor's report, the auditor

¹ However, see section 711.10—13 as to an auditor's obligation with respect to audited financial statements included in registration statements filed under the Securities Act of 1933 between the date of the auditor's report and the effective date of the registration statement. [Reference changed by issuance of Statement on Auditing Standards No. 37.]

should take action in accordance with the procedures set out in subsequent paragraphs if the nature and effect of the matter are such that (a) his report would have been affected if the information had been known to him at the date of his report and had not been reflected in the financial statements and (b) he believes there are persons currently relying or likely to rely on the financial statements who would attach importance to the information. With respect to (b), consideration should be given, among other things, to the time elapsed since the financial statements were issued.

.06 When the auditor has concluded, after considering (a) and (b) in paragraph .05, that action should be taken to prevent future reliance on his report, he should advise his client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report. When the client undertakes to make appropriate disclosure, the method used and the disclosure made will depend on the circumstances.

- a. If the effect on the financial statements or auditor's report of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report. Generally, only the most recently issued audited financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.²
- b. When issuance of financial statements accompanied by the auditor's report for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements pursuant to subparagraph (a).³
- c. When the effect on the financial statements of the subsequently discovered information cannot be determined without a prolonged investigation, the issuance of revised financial statements and auditor's report would necessarily be delayed. In this circumstance, when it appears that the information will require a revision of the statements, appropriate disclosure would consist of notification by the client to persons who are known to be relying or who are likely to rely on the financial statements and the related report that they should not be relied upon, and that revised financial statements and auditor's report will be issued upon completion of an investigation. If applicable, the client should be advised to discuss with the Securities and Exchange Commission, stock exchanges, and appropriate regulatory agencies the disclosure to be made or other measures to be taken in the circumstances.

.07 The auditor should take whatever steps he deems necessary to satisfy himself that the client has made the disclosures specified in paragraph .06.

² See paragraphs 26 and 27 of Accounting Principles Board Opinion No. 9 [AC section A35.107—.108] and paragraphs 36 and 37 of Opinion No. 20 [AC section A35.105] regarding disclosure of adjustments applicable to prior periods.

³ Ibid.

.08 If the client refuses to make the disclosures specified in paragraph .06, the auditor should notify each member of the board of directors of such refusal and of the fact that, in the absence of disclosure by the client, the auditor will take steps as outlined below to prevent future reliance upon his report. The steps that can appropriately be taken will depend upon the degree of certainty of the auditor's knowledge that there are persons who are currently relying or who will rely on the financial statements and the auditor's report, and who would attach importance to the information, and the auditor's ability as a practical matter to communicate with them. Unless the auditor's attorney recommends a different course of action, the auditor should take the following steps to the extent applicable:

- a. Notification to the client that the auditor's report must no longer be associated with the financial statements.
- b. Notification to regulatory agencies having jurisdiction over the client that the auditor's report should no longer be relied upon.
- c. Notification to each person known to the auditor to be relying on the financial statements that his report should no longer be relied upon. In many instances, it will not be practicable for the auditor to give appropriate individual notification to stockholders or investors at large, whose identities ordinarily are unknown to him; notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the auditor to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure. The Securities and Exchange Commission and the stock exchanges are appropriate agencies for this purpose as to corporations within their jurisdictions.

.09 The following guidelines should govern the content of any disclosure made by the auditor in accordance with paragraph .08 to persons other than his client:

- a. If the auditor has been able to make a satisfactory investigation of the information and has determined that the information is reliable:
 - (i) The disclosure should describe the effect the subsequently acquired information would have had on the auditor's report if it had been known to him at the date of his report and had not been reflected in the financial statements. The disclosure should include a description of the nature of the subsequently acquired information and of its effect on the financial statements.
 - (ii) The information disclosed should be as precise and factual as possible and should not go beyond that which is reasonably necessary to accomplish the purpose mentioned in the preceding subparagraph (i). Comments concerning the conduct or motives of any person should be avoided.
- b. If the client has not cooperated and as a result the auditor is unable to conduct a satisfactory investigation of the information, his disclosure need not detail the specific information but can merely indicate that information has come to his attention which his client has not cooperated in attempting to substantiate and that, if the informa-

tion is true, the auditor believes that his report must no longer be relied upon or be associated with the financial statements. No such disclosure should be made unless the auditor believes that the financial statements are likely to be misleading and that his report should not be relied on.

.10 The concepts embodied in this section are not limited solely to corporations but apply in all cases where financial statements have been examined and reported on by independent auditors.

AU Section 600

OTHER TYPES OF
REPORTS

... special reports ... reports on the application of
accounting principles ... letters for underwriters
... reporting on internal accounting control ...

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AU Section 621

Special Reports¹

The Auditing Standards Board has recently issued an exposure draft of a proposed Statement on Auditing Standards titled *Special Reports*, which would supersede the provisions of this section. Practitioners may find that exposure draft helpful when drafting special reports that conform to the new report language in section 508, *Reports on Audited Financial Statements*.

(Supersedes section 620)

Sources: SAS No. 14; SAS No. 35.

See section 9621 for interpretations of this section.

Effective with respect to engagements to issue special reports on data for periods beginning after December 31, 1976, unless otherwise indicated.

.01 This section applies to auditors' reports issued in connection with—

- a. Financial statements that are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles (paragraphs .02—.08).
- b. Specified elements, accounts, or items of a financial statement* (paragraphs .09—.14).
- c. Compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements (paragraphs .18—.19).
- d. Financial information presented in prescribed forms or schedules that require a prescribed form of auditor's report (paragraphs .20—.21).

Reports that meet the foregoing criteria are *special reports* or *special purpose reports*. This section does not apply to reports issued in connection with (a) reviews of interim financial information, (b) financial forecasts, projections, or feasibility studies, or (c) compliance with aspects of contractual agreements or regulatory requirements unrelated to financial statements.

¹ This section amends the second sentence of section 410.02 by the addition of the following footnote:

When an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the first standard of reporting is satisfied by disclosing in the auditor's report that the statements are not intended to conform with generally accepted accounting principles and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used (see section 621.02—.08, *Special Reports*).

* See also section 622.

Reports on Financial Statements Prepared in Accordance With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles

.02 Generally accepted auditing standards are applicable when an auditor examines and reports on any financial statement.² The term *financial statement* refers to a presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a comprehensive basis of accounting. For reporting purposes, the independent auditor should consider each of the following types of financial presentations to be a financial statement:

- a. Balance sheet.
- b. Statement of income.
- c. Statement of retained earnings.
- d. Statement of changes in financial position.
- e. Statement of changes in owners' equity.
- f. Statement of assets and liabilities that does not include owners' equity accounts.
- g. Statement of revenue and expenses.
- h. Summary of operations.
- i. Statement of operations by product lines.
- j. Statement of cash receipts and disbursements.

.03 An independent auditor's judgment concerning the overall presentation of financial statements needs to be applied within an identifiable framework (see section 411, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*). Normally the framework is provided by generally accepted accounting principles, and the auditor's judgment in forming an opinion is applied accordingly (see section 411.04). In some circumstances, however, a comprehensive basis of accounting other than generally accepted accounting principles may be used.

.04 For purposes of this section, a comprehensive basis of accounting other than generally accepted accounting principles is a basis to which at least one of the following descriptions applies:

- a. A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a government regulatory agency to whose jurisdiction the entity is subject. Examples are a basis of accounting prescribed in a uniform system of accounts that the Interstate Commerce Commission requires railroad companies to use and a basis of accounting insurance companies use pursuant to the rules of a state insurance commission.
- b. A basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.

² A financial statement may be, for example, that of a corporation, a consolidated group of corporations, a combined group of affiliated entities, a not-for-profit organization, a government unit, an estate or trust, a partnership, a proprietorship, a segment of any of these, or an individual.

- c. The cash receipts and disbursements basis of accounting, and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes.
- d. A definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting.

Unless one of the foregoing descriptions applies, reporting under the provisions of paragraph .05 is not permitted.

.05 When reporting on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, as defined in paragraph .04, an independent auditor should include all of the following in his report:

- a. A paragraph identifying the financial statements examined and stating whether the examination was made in accordance with generally accepted auditing standards.
- b. A paragraph that—
 - (i) States, or preferably refers to the note to the financial statements that states, the basis of presentation of the financial statements on which the auditor is reporting.
 - (ii) Refers to the note to the financial statements that describes how the basis of presentation differs from generally accepted accounting principles. (The monetary effect of such differences need not be stated.)
 - (iii) States that the financial statements are not intended to be presented in conformity with generally accepted accounting principles.
- c. A paragraph that expresses the auditor's opinion (or disclaims an opinion) on whether—
 - (i) The financial statements are presented fairly in conformity with the basis of accounting described.³ If the auditor concludes that the financial statements are not presented fairly on the basis of accounting described, he should disclose all the substantive reasons for that conclusion in an additional explanatory paragraph(s) of his report and should include in the opinion paragraph appropriate modifying language and a reference to the explanatory paragraph(s).
 - (ii) The disclosed basis of accounting used has been applied in a manner consistent with that of the preceding period.

When reporting on financial statements prepared in accordance with the requirements or financial reporting provisions of a government regulatory agency (see paragraph .04a), the auditor may use the form of reporting prescribed in this paragraph only if the financial statements are intended solely for filing with a regulatory agency or if additional distribution is

³ In reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used.

recognized as appropriate by an AICPA accounting or audit guide or auditing interpretation.^{4,*}

.06 Unless the financial statements are intended to be presented in accordance with a "comprehensive basis of accounting other than generally accepted accounting principles" (as defined in paragraph .04), the auditor should use the standard form of report (see section 509.07, *Reports on Audited Financial Statements*, in Appendix G) modified as appropriate (see section 509.15—17 in Appendix G) because of the departures from generally accepted accounting principles.

.07 Terms such as "balance sheet," "statement of financial position," "statement of income," "statement of operations," "statement of changes in financial position," or similar unmodified titles are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or changes in financial position in conformity with generally accepted accounting principles. Consequently, the auditor

⁴ In view of the provisions of this paragraph, the third sentence of section 544.02 is amended by the addition of the following footnote:

When reporting on financial statements of a regulated company that are prepared in accordance with the requirements or financial reporting provisions of a government regulatory agency to whose jurisdiction the company is subject, the auditor may report on the financial statements as being prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles (see section 621.02—.08, *Special Reports*). Reports of this nature, however, should be issued only if the financial statements are intended solely for filing with the regulatory agency or if additional distribution is recognized as appropriate by an AICPA accounting or audit guide or auditing interpretation.

Also, section 544.04 is amended to read as follows:

When financial statements of a regulated company are prepared in accordance with a basis of accounting prescribed by its supervisory agency or the financial reporting provisions of another agency, the independent auditor may also be requested to report on their fair presentation in conformity with such prescribed basis of accounting in presentations other than filings with the company's regulatory agency. In those circumstances, except when such reporting is recognized as appropriate by an AICPA accounting or audit guide or auditing interpretation, the auditor should use the standard form of report (see section 509.07, *Reports on Audited Financial Statements*, in Appendix G), modified as appropriate (see section 509.15—17 in Appendix G) because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting.

* This form of reporting is appropriate, even though by law or regulation the accountant's report may be made a matter of public record. [As amended, April 1981, by Statement on Auditing Standards No. 35.] (See section 622.)

should consider whether the financial statements he is reporting on are suitably titled. For example, a cash-basis financial statement might be titled "statement of assets and liabilities arising from cash transactions," or "statement of increases or decreases in funds arising from cash transactions," and a financial statement prepared on a statutory or regulatory basis might be titled "statement of income—statutory basis." If the auditor believes that the financial statements are not suitably titled, he should modify his report to disclose his reservations.

.08 The following are illustrations of reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.

Financial Statements Prepared on a Basis Prescribed by a Regulatory Agency Solely for Filing With That Agency⁵

We have examined the statement of admitted assets, liabilities, and surplus—statutory basis of XYZ Insurance Company as of December 31, 19XX, and the related statements of income—statutory basis and changes in surplus—statutory basis for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in Note X, the Company's policy is to prepare its financial statements on the basis of accounting practices prescribed or permitted by the Insurance Department of [State]. These practices differ in some respects from generally accepted accounting principles. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles. This report is intended solely for filing with regulatory agencies and is not intended for any other purpose.

In our opinion, the financial statements referred to above present fairly the admitted assets, liabilities and surplus of XYZ Insurance Company as of December 31, 19XX, and the results of its operations and changes in its surplus for the year then ended, on the basis of accounting described in Note X, which basis has been applied in a manner consistent with that of the preceding year.

Financial Statements Prepared on the Entity's Income Tax Basis

We have examined the statement of assets, liabilities, and capital— income tax basis of ABC Partnership as of December 31, 19XX, and the related statements of revenue and expenses—income tax basis and of changes in partners' capital accounts—income tax basis for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and

⁵ See paragraph .05 concerning what additional distribution of the financial statements or the auditor's report is appropriate.

such other auditing procedures as we considered necessary in the circumstances.

As described in Note X, the Partnership's policy is to prepare its financial statements on the accounting basis used for income tax purposes; consequently, certain revenue and the related assets are recognized when received rather than when earned, and certain expenses are recognized when paid rather than when the obligation is incurred. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly the assets, liabilities, and capital of ABC Partnership as of December 31, 19XX, and its revenue and expenses and changes in its partners' capital accounts for the year then ended, on the basis of accounting described in Note X, which basis has been applied in a manner consistent with that of the preceding year.

Financial Statements Prepared on the Cash Basis

We have examined the statement of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19XX, and the related statement of revenue collected and expenses paid for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in Note X, the Company's policy is to prepare its financial statements on the basis of cash receipts and disbursements; consequently, certain revenue and the related assets are recognized when received rather than when earned, and certain expenses are recognized when paid rather than when the obligation is incurred. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19XX, and the revenue collected and expenses paid during the year then ended, on the basis of accounting described in Note X, which basis has been applied in a manner consistent with that of the preceding year.

Reports on Specified Elements, Accounts, or Items of a Financial Statement

.09 An independent auditor may be requested to report on one or more specified elements, accounts, or items of a financial statement. In such an engagement, the specified element(s), account(s), or item(s) may be presented

in the report or in a document accompanying the report. Such a report normally falls into one of the following categories.

- a. A report expressing an opinion on one or more specified elements, accounts, or items of a financial statement, such as rentals, royalties, a profit participation, or a provision for income taxes (see paragraphs .10—.14).
- b. A report relating to the results of applying agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement.*

Reports Expressing an Opinion on One or More Specified Elements, Accounts, or Items of a Financial Statement

.10 In reporting on one or more specified elements, accounts, or items of a financial statement, the auditor should plan his examination and prepare his report with a view to the purpose of the engagement. The general standards, the standards of field work, and the third and fourth standards of reporting are applicable to an engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement; however, since specified elements, accounts, or items of a financial statement are not considered to be a financial statement, the first standard of reporting does not apply. The second standard of reporting as to consistency is applicable if the elements, accounts, or items on which the auditor is to express an opinion are prepared in accordance with generally accepted accounting principles. Examples of items that ordinarily are not prepared in accordance with generally accepted accounting principles are those prepared in accordance with the provisions of a contract, law, or government regulation.

.11 An engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement may be undertaken as a separate engagement or in conjunction with an examination of financial statements. In such an engagement, an auditor expresses his opinion on each of the specified elements, accounts, or items encompassed by his report; therefore, the measurement of materiality must be related to each individual element, account, or item examined rather than to the aggregate thereof or to the financial statements taken as a whole. Consequently, an examination of a specified element, account, or item for purposes of reporting thereon is usually more extensive than if the same information were being considered in conjunction with an examination of financial statements taken as a whole. Also, many financial statement elements are interrelated, for example, sales and receivables; inventory and payables; buildings and equipment, and depreciation. The auditor should satisfy himself that elements, accounts, or items that are interrelated with those on which he has been engaged to express an opinion have been considered in expressing his opinion.

.12 The auditor should not report on specified elements, accounts, or items included in financial statements on which he has expressed an adverse opinion or disclaimed an opinion based on an audit, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements (see section 509.48 in Appendix G). However, in those circumstances, an auditor would be able to report on one or more specified elements, accounts, or items of a financial statement provided that the matters to be reported on and the related scope of the examination were not intended to and did not encompass so many elements, accounts, or items as to constitute a major portion of the

* See section 622.

financial statement. Also, the report should not accompany the financial statements of the entity.

.13 When an independent auditor is engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement, such as rentals, royalties, a profit participation, or a provision for income taxes, his report should—

- a. Identify the specified elements, accounts, or items examined.
- b. State whether the examination was made in accordance with generally accepted auditing standards and, if applicable, that it was made in conjunction with an examination of financial statements. (Also, if applicable, any modification of the auditor's standard report on those statements should be indicated.)
- c. Identify the basis on which the specified elements, accounts, or items are presented and, when applicable, any agreements specifying such basis.
- d. Describe and indicate the source of significant interpretations made by the client in the course of the engagement relating to the provisions of a relevant agreement.
- e. Indicate whether in his opinion the specified elements, accounts, or items are presented fairly on the basis indicated.
- f. If applicable, indicate whether in his opinion the disclosed basis has been applied in a manner consistent with that of the preceding period.

When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor, to provide more information as to the scope of his examination, may wish to describe certain auditing procedures applied.

.14 The following are illustrations of reports expressing an opinion on one or more specified elements, accounts, or items of a financial statement.

Report Relating to Amount of Sales for the Purpose of Computing Rental

Board of Directors
ABC Company

We have examined the schedule of gross sales (as defined in the lease agreement dated March 4, 19XX, between ABC Company, as lessor, and

XYZ Stores Corporation, as lessee) of XYZ Stores Corporation at its Main Street store, [City], [State], for the year ended December 31, 19XX. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the schedule of gross sales referred to above presents fairly the gross sales of XYZ Stores Corporation at its Main Street store, [City], [State], for the year ended December 31, 19XX, on the basis specified in the lease agreement referred to above.

Report Relating to Royalties

Board of Directors

XYZ Corporation

We have examined the schedule of royalties applicable to engine production of the Q Division of XYZ Corporation for the year ended December 31, 19XX, under the terms of a license agreement dated May 14, 19XX, between ABC Company and XYZ Corporation. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

We have been informed that, under XYZ Corporation's interpretation of the agreement referred to above, royalties were based on the number of engines produced after giving effect to a reduction for production retirements that were scrapped, but without a reduction for field returns that were scrapped, even though the field returns were replaced with new engines without charge to customers. This treatment is consistent with that followed in prior years.

In our opinion, the schedule of royalties referred to above presents fairly the number of engines produced by the Q Division of XYZ Corporation during the year ended December 31, 19XX, and the amount of royalties applicable thereto under the license agreement referred to above, on the basis indicated in the preceding paragraph.

Report on a Profit Participation⁶

Mr. John Smith

City, State

We have examined XYZ Company's schedule of John Smith's profit participation for the year ended December 31, 19X1. Our examination was made in accordance with generally accepted auditing standards and,

⁶ A report on an examination of a schedule of profit participation should be issued only if the auditor has examined the financial statements on which the participation is based.

accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We have examined the financial statements of XYZ Company for the year ended December 31, 19X1, and have issued our report thereon dated March 10, 19X2.

We have been informed that the documents that govern the determination of John Smith's profit participation are (a) the employment agreement between John Smith and XYZ Company dated February 1, 19X0, (b) the production and distribution agreement between XYZ Company and Television Network Incorporated dated March 1, 19X0, and (c) the studio facilities agreement between XYZ Company and QRX Studios dated April 1, 19X0, as amended November 1, 19X0.

In our opinion, the schedule of profit participation referred to above presents fairly John Smith's participation in the profits of XYZ Company for the year ended December 31, 19X1, in accordance with the provisions of the agreements referred to in the preceding paragraph.

Report Relating to the Adequacy of a Provision for Income Taxes in Financial Statements⁷

Board of Directors

XYZ Company, Inc.

We have examined the financial statements of XYZ Company, Inc., for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In the course of our examination, we examined the provision for federal and state income taxes for the year ended June 30, 19XX, included in the Company's financial statements referred to in the preceding paragraph. We also reviewed the federal and state income tax returns filed by the Company that are subject to examination by the respective taxing authorities.

In our opinion, the Company has paid or has provided adequate accruals in the financial statements referred to above for the payment of all federal and state income taxes, and has provided for related deferred income taxes,

⁷ A report relating to the adequacy of a provision for income taxes in financial statements should be issued only if the auditor has examined the financial statements in which the provision appears.

If a significant period of time has elapsed between the date of the auditor's report on the financial statements and the date he is reporting on the provision for income taxes, the auditor may wish to include the following paragraph in his report:

Because we have not examined any financial statements of XYZ Company, Inc., as of any date or for any period subsequent to June 30, 19XX, we have no knowledge of the effects, if any, on the income tax provision of events that may have occurred subsequent to the date of our examination.

applicable to fiscal 19XX and prior fiscal years, that could be reasonably estimated at the time of our examination of the financial statements of XYZ Company, Inc., for the year ended June 30, 19XX.

Reports Relating to the Results of Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement

[.15—.17] [Superseded, April 1981, by Statement on Auditing Standards No. 35.] (See section 622.)

Reports on Compliance With Aspects of Contractual Agreements or Regulatory Requirements Related to Audited Financial Statements

.18 Companies may be required by contractual agreements, such as bond indentures and certain types of loan agreements, or by regulatory agencies to furnish compliance reports by independent auditors. For example, loan agreements usually impose on borrowers a variety of covenants involving matters such as payments into sinking funds, payments of interest, maintenance of current ratio, restriction of dividend payments, and use of the proceeds of sales of property. They usually also require the borrower to furnish annual financial statements that have been examined by an independent auditor. In some instances, the lenders or their trustees may request assurance from the independent auditor that the borrower has complied with the covenants of the agreement relating to accounting or auditing matters. The independent auditor normally satisfies this request by giving negative assurance relative to the applicable covenants. This assurance may be given in a separate report or in one or more paragraphs of the auditor's report accompanying the financial statements. Such assurance, however, should not be given unless the auditor has examined the financial statements to which the contractual agreements or regulatory requirements relate.

.19 The expression of negative assurance should specify that it is being given in connection with an examination of the financial statements. The auditor may also wish to state that the examination was not directed primarily toward obtaining knowledge regarding compliance. A separate report giving negative assurance should contain a paragraph stating that the financial statements have been examined, the date of the report thereon, and whether the examination was made in accordance with generally accepted auditing standards. The following are examples of reports that might be issued.

Report on Compliance With Contractual Provisions Given in a Separate Report

We have examined the balance sheet of XYZ Company as of December 31, 19X1, and the related statements of income, retained earnings, and changes in financial position for the year then ended, and have issued our

report thereon dated February 16, 19X2. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In connection with our examination, nothing came to our attention that caused us to believe that the Company was not in compliance with any of the terms, covenants, provisions, or conditions of section XX to XX, inclusive, of the Indenture dated July 21, 19X0, with ABC Bank. However, it should be noted that our examination was not directed primarily toward obtaining knowledge of such noncompliance.

Report on Compliance With Contractual Provisions Given in Auditor's Report Accompanying Financial Statements

We have examined the balance sheet of XYZ Company as of December 31, 19X1, and the related statements of income, retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of XYZ Company as of December 31, 19X1, and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

In connection with our examination, nothing came to our attention that caused us to believe that the Company was not in compliance with any of the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 19X0, with ABC Bank. However, it should be noted that our examination was not directed primarily toward obtaining knowledge of such noncompliance.

Report on Compliance With Regulatory Requirements

We have examined the balance sheet of XYZ Company as of December 31, 19X1, and the related statements of income, retained earnings, and changes in financial position for the year then ended, and have issued our report thereon dated March 5, 19X2. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In connection with our examination, nothing came to our attention that caused us to believe that the Company had failed to comply with the limitation and increased investment requirement in section 993(d)(2) and (3) of the Internal Revenue Code of 1954. However, it should be noted that our examination was not directed primarily toward obtaining knowledge of noncompliance with such requirements.

Financial Information Presented in Prescribed Forms or Schedules

.20 Printed forms or schedules designed by the bodies with which they are to be filed often prescribe the wording of an auditor's report. Many of these forms are not acceptable to independent auditors because the prescribed form of auditor's report does not conform to the applicable professional reporting standards. For example, the prescribed language of the report may call for assertions by the auditor that are not consistent with his function or responsibility.

.21 Some report forms can be made acceptable by inserting additional wording; others can be made acceptable only by complete revision. When a printed report form calls upon an independent auditor to make an assertion that he believes he is not justified in making, he should reword the form or attach a separate report. In those situations, the reporting provisions of paragraph .05 may be appropriate.

Effective Date

.22 Statements on Auditing Standards generally are effective at the time of their issuance. However, since the provisions of this section change certain reporting practices heretofore considered acceptable, this section will be effective with respect to engagements to issue special reports on data for periods beginning after December 31, 1976. For an entity having a fiscal year of 52 or 53 weeks ending in the last seven days in December or the first seven days in January, reference to December 31, 1976 means the date in December or January on which the fiscal year ends. Earlier application of this section is encouraged, but not required.

→ The next page is 1101. ←

AU Section 622

Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement

(Supersedes Statement on Auditing Standards No. 14, paragraphs 15—17)¹

Source: SAS No. 35.

Issue date, unless otherwise indicated: April, 1981.

.01 An accountant may accept an engagement in which the scope is limited to applying to one or more specified elements, accounts, or items of a financial statement agreed-upon procedures² that are not sufficient to enable him to express an opinion on the specified elements, accounts, or items, provided (a) the parties involved have a clear understanding of the procedures to be performed and (b) distribution of the report is to be restricted to named parties involved.³

.02 To satisfy the requirement that the parties involved have a clear understanding of the procedures to be performed, ordinarily the accountant should meet with the named parties involved to discuss the procedures to be followed. This discussion may include describing to the named parties procedures frequently followed in similar types of engagements. Sometimes the accountant may not be able to discuss the procedures directly with all the parties who will receive the report. In such circumstances, the accountant may satisfy the requirement that the parties involved have a clear understanding by applying any one of the following or similar procedures:

- a. Discussing the procedures to be applied with legal counsel or other appropriate representatives of the parties involved, such as a trustee, a receiver, or a creditors' committee.

¹ This section also amends section 504, *Association With Financial Statements*, by deleting from the last sentence of section 504.20 the words "as specified in section 621, the financial statements of the entity may not accompany this special report." Also, this section withdraws the auditing interpretation "Understanding of Agreed-Upon Procedures," February 1980 (section 9621.32—.33), by incorporating the guidance of the interpretation into paragraph .02 of this section. The auditing interpretation entitled "Reports on Engagements Solely to Meet State Regulatory Examination Requirements," October 1979 (section 9621.15—.16) is also withdrawn, and a footnote is added to the end of section 621.05 to state, "This form of reporting is appropriate, even though by law or regulation the accountant's report may be made a matter of public record."

² Mere reading of a specific element, account, or item does not constitute a procedure sufficient to permit an accountant to report on the results of applying agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement.

³ The form of reporting described in paragraph .04 is appropriate, even though by law or regulation the accountant's report may be made a matter of public record.

- b. Reviewing relevant correspondence from the parties.
- c. Comparing the procedures to be applied to written requirements of a supervisory agency, such as a bank regulatory agency that receives a report in connection with a bank directors' examination.
- d. Distributing a draft of the report or a copy of the client's engagement letter to the parties involved with a request for their comments before the report is issued.

.03 The second and third standards of field work and the standards of reporting do not apply to an engagement that is limited to applying agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement; however, the general standards and the first standard of field work are applicable.

.04 The accountant's report on the results of applying agreed-upon procedures should (a) indicate the specified elements, accounts, or items to which the agreed-upon procedures were applied, (b) indicate the intended distribution of the report, (c) enumerate the procedures performed, (d) state the accountant's findings, (e) disclaim an opinion with respect to the specified elements, accounts, or items, and (f) state that the report relates only to the elements, accounts, or items specified, and does not extend to the entity's financial statements taken as a whole.⁴

.05 If the accountant has no adjustments to propose to the specified elements, accounts, or items, he may include a comment to that effect in his report. For example, the following language might be included: "In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the (specified elements, accounts, or items) should be adjusted." Also, the accountant may wish to indicate that had he performed additional procedures with respect to the specified elements, accounts, or items or had he made an examination of the financial statements in accordance with generally accepted auditing standards, (other) matters might have come to his attention that would have been reported.

.06 The following are illustrations of the types of reports that might be issued when an engagement is limited to applying to one or more specified elements, accounts, or items of a financial statement agreed-upon procedures that are not sufficient to enable the accountant to express an opinion on the elements, accounts, or items.

⁴ When the accountant consents to the inclusion of his report on the results of applying agreed-upon procedures in a document or written communication containing the entity's financial statements, he should look to section 504, *Association With Financial Statements*, or to Statement on Standards for Accounting and Review Services No. 1 [AR section 100], *Compilation and Review of Financial Statements*, as appropriate, for guidance on his responsibility pertaining to the financial statements.

Report in Connection With a Proposed Acquisition

Board of Directors

X Company

We have applied certain agreed-upon procedures, as discussed below, to accounting records of Y Company, Inc., as of December 31, 19XX, solely to assist you in connection with the proposed acquisition of Y Company, Inc. It is understood that this report is solely for your information and is not to be referred to or distributed for any purpose to anyone who is not a member of management of X Company. Our procedures and findings are as follows:

a. We reconciled cash on deposit with the following banks to the balances in the respective general ledger accounts and obtained confirmation of the related balances from the banks.

<i>Bank</i>	<i>Balance Per General Ledger</i>
ABC National Bank	\$ 5,000
DEF State Bank	13,776
XYZ Trust Company—regular account	86,912
XYZ Trust Company—payroll account	5,000

b. We obtained an aged trial balance of the accounts receivable subsidiary records, traced the age and amounts of approximately 10 percent of the accounts to the accounts receivable ledger, and added the trial balance and compared the total with the balance in the general ledger control account. We mailed requests for positive confirmation of balances to 150 customers. The differences disclosed in confirmation replies were minor in amount and nature, and we reconciled them to our satisfaction. The results are summarized as follows:

	<i>Accounts Receivable Aging and Confirmation</i>		
	<i>Account Balance</i>	<i>Confirmation Requested</i>	<i>Results Received</i>
Current	\$156,000	\$ 76,000	\$ 65,000
Past due:			
Less than one month	60,000	30,000	19,000
One to three months	36,000	18,000	10,000
Over three months	48,000	48,000	8,000
	<u>\$300,000</u>	<u>\$172,000</u>	<u>\$102,000</u>

Because the above procedures do not constitute an examination made in accordance with generally accepted auditing standards, we do not express an opinion on any of the accounts or items referred to above. In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the specified accounts or items should be adjusted. Had we performed additional procedures or had we made an examination of the financial statements in accordance with generally accepted auditing standards, matters might have come to our attention that would have been

reported to you. This report relates only to the accounts and items specified above and does not extend to any financial statements of Y Company, Inc., taken as a whole.

Report in Connection With Claims of Creditors

Trustee

XYZ Company

At your request, we have performed the procedures enumerated below with respect to the claims of creditors of XYZ Company as of May 31, 19XX, set forth in the accompanying schedules. Our review was made solely to assist you in evaluating the reasonableness of those claims, and our report is not to be used for any other purpose. The procedures we performed are summarized as follows:

- a. We compared the total of the trial balance of accounts payable at May 31, 19XX, prepared by the company, to the balance in the company's related general ledger account.
- b. We compared the claims received from creditors to the trial balance of accounts payable.
- c. We examined documentation submitted by the creditors in support of their claims and compared it to documentation in the company's files, including invoices, receiving records, and other evidence of receipt of goods or services.

Our findings are presented in the accompanying schedules. Schedule A lists claims that are in agreement with the company's records. Schedule B lists claims that are not in agreement with the company's records and sets forth the differences in amounts.

Because the above procedures do not constitute an examination made in accordance with generally accepted auditing standards, we do not express an opinion on the accounts payable balance as of May 31, 19XX. In connection with the procedures referred to above, except as set forth in Schedule B, no matters came to our attention that caused us to believe that the accounts payable balance might require adjustment. Had we performed additional procedures or had we made an examination of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you. This report relates only to the accounts and items specified above and does not extend to any financial statements of XYZ Company, taken as a whole.

→ *The next page is 1109.* ←

AU Section 625

Reports on the Application of Accounting Principles

Source: SAS No. 50.

Issue date, unless otherwise indicated: July, 1986.

.01 Accounting principles evolve in response to changing economic conditions and to new transactions and financial products.¹ Agreement frequently does not exist about how accounting principles should be applied to those transactions and products. Management, accountants, and intermediaries often consult with professionals, including other accountants, on the application of accounting principles to those transactions and products or to increase their knowledge of specific financial reporting issues.² Such consultations are often useful because they may provide information and insights not otherwise available.

Applicability

.02 This section provides guidance that an accountant in public practice ("reporting accountant"), either in connection with a proposal to obtain a new client or otherwise, should apply³—

- a. When preparing a written report on the application of accounting principles to specified transactions, either completed or proposed ("specific transactions").
- b. When requested to provide a written report on the type of opinion that may be rendered on a specific entity's financial statements.
- c. When preparing a written report to intermediaries on the application of accounting principles not involving facts or circumstances of a particular principal ("hypothetical transactions").

This section also applies to oral advice on the application of accounting principles to a specific transaction, or the type of opinion that may be rendered on an entity's financial statements, when the reporting accountant concludes the advice is intended to be used by a principal to the transaction as an important factor considered in reaching a decision.

.03 This section does not apply to an accountant ("continuing accountant") who has been engaged to report on financial statements, to engagements either to assist in litigation involving accounting matters or to provide expert

¹ Accounting principles include generally accepted accounting principles and other comprehensive bases of accounting. See section 621, *Special Reports*, paragraph .04 for a description of other comprehensive bases of accounting.

² "Intermediaries" refers to those parties who may advise one or more principals to a transaction, and may include, but are not limited to, attorneys and investment, merchant, and commercial bankers.

³ See Rule 91.11 [ET section 91.11] of the AICPA Code of Professional Ethics for a definition of "practice of public accounting."

testimony in connection with such litigation, or to professional advice given to another accountant in public practice.

.04 This section also does not apply to communications such as position papers prepared by an accountant for the purpose of presenting views on an issue involving the application of accounting principles or the type of opinion that may be rendered on an entity's financial statements. Position papers include newsletters, articles, speeches and texts thereof, lectures and other forms of public presentations, and letters for the public record to professional and governmental standard-setting bodies. However, if communications of the type discussed in this paragraph are intended to provide guidance on the application of accounting principles to a specific transaction, or on the type of opinion that may be rendered on a specific entity's financial statements, the provisions of this section should be followed.

Performance Standards

.05 The reporting accountant should exercise due professional care in performing the engagement and should have adequate technical training and proficiency. The reporting accountant should also plan the engagement adequately, supervise the work of assistants, if any, and accumulate sufficient information to provide a reasonable basis for the professional judgment described in the report. The reporting accountant should consider who is the requester of the report, the circumstances under which the request is made, the purpose of the request, and the requester's intended use of the report.

.06 To aid in forming a judgment, the reporting accountant should perform the following procedures: (a) obtain an understanding of the form and substance of the transaction(s); (b) review applicable generally accepted accounting principles (see section 411, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report*); (c) if appropriate, consult with other professionals or experts; and (d) if appropriate, perform research or other procedures to ascertain and consider the existence of creditable precedents or analogies.

.07 When evaluating accounting principles or determining the type of opinion that may be rendered on an entity's financial statements at the request of a principal, or an intermediary acting for a principal, that relate to a specific transaction, or to a specific entity's financial statements, the reporting accountant should consult with the continuing accountant of the principal to ascertain all the available facts relevant to forming a professional judgment. The continuing accountant may provide information not otherwise available to the reporting accountant regarding, for example, the following: the form and substance of the transaction; how management has applied accounting principles to similar transactions; whether the method of accounting recommended by the continuing accountant is disputed by management; or whether the continuing accountant has reached a different conclusion on the application of accounting principles or the type of opinion that may be rendered on the entity's financial statements. The reporting accountant should explain to the principal or intermediary the need to consult with the continuing accountant, request permission to do so, and request the principal to authorize the continuing accountant to respond fully to the reporting accountant's inquiries. The responsibilities of a principal's continuing accountant to respond to inquiries by the reporting accountant are the same as the responsibilities of a predecessor auditor to respond to inquiries by a successor auditor. See section 315, *Communications Between Predecessor and Successor Auditors*, paragraph .07.

Reporting Standards

.08 The accountant's written report should be addressed to the principal to the transaction or to the intermediary, and should ordinarily include the following:⁴

- a. A brief description of the nature of the engagement and a statement that the engagement was performed in accordance with applicable AICPA standards.
- b. A description of the transaction(s), a statement of the relevant facts, circumstances, and assumptions, and a statement about the source of the information. Principals to specific transactions should be identified, and hypothetical transactions should be described as involving nonspecific principals (for example, Company A, Company B).
- c. A statement describing the appropriate accounting principle(s) to be applied or type of opinion that may be rendered on the entity's financial statements, and, if appropriate, a description of the reasons for the reporting accountant's conclusion.
- d. A statement that the responsibility for the proper accounting treatment rests with the preparers of the financial statements, who should consult with their continuing accountants.
- e. A statement that any difference in the facts, circumstances, or assumptions presented may change the report.

.09 The following is an illustration of sections of the report described in paragraph .08.

Introduction

We have been engaged to report on the appropriate application of generally accepted accounting principles to the specific (hypothetical) transaction described below. This report is being issued to the ABC Company (XYZ Intermediaries) for assistance in evaluating accounting principles for the described specific (hypothetical) transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

Description of Transaction

The facts, circumstances, and assumptions relevant to the specific (hypothetical) transaction as provided to us by the management of the ABC Company (XYZ Intermediaries) are as follows:

Appropriate Accounting Principles

[Text discussing principles]

Concluding Comments

The ultimate responsibility for the decision on the appropriate application of generally accepted accounting principles for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountants. Our judgment on the appropriate application of generally accepted accounting principles for the described specific (hypothetical) transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

[The next page is 1121.]

⁴ Although the reporting standards in this section apply only to written reports, accountants may find this guidance useful in presenting oral advice.

AU Section 634

Letters for Underwriters

Source: SAS No. 49.

See section 9634 for interpretations of this section.

Issue date, unless otherwise indicated: September, 1984.

.01 The services of independent certified public accountants include examination of financial statements and schedules contained in registration statements filed with the Securities and Exchange Commission (the SEC) under the Securities Act of 1933 (the Act). In connection with this type of service, accountants often are called upon to confer with clients, underwriters, and their respective counsel concerning the accounting and auditing requirements of the Act and of the SEC, as well as to perform other services. One of these other services is the issuance of letters for underwriters, commonly called *comfort letters*, which are generally concerned with the subjects described in paragraph .06.

.02 Much of the uncertainty and consequent risk of misunderstanding with regard to the nature and scope of comfort letters has arisen from a lack of recognition of the necessarily limited nature of the comments that accountants can properly make with respect to financial information, in a registration statement, that has not been examined in conformity with generally accepted auditing standards and accordingly is not covered by their opinion. Underwriters, in requesting comfort letters, are generally seeking assistance on matters of importance to them. They wish to perform a "reasonable investigation" of financial and accounting data not "expertized" (covered by a report of independent accountants, who consent to be named as experts, based on an examination made in accordance with generally accepted auditing standards) as a defense against possible claims under the Act. Accountants have a corresponding wish, arising in response to the same statutory phrase, *reasonable investigation*, with respect to audited financial statements included in a

Note: This section supersedes section 631, *Letters for Underwriters*. The changes to section 631 are in response to revisions of financial reporting requirements of the SEC and other developments in auditing and reporting practices. The principal changes are to add or revise guidance on the following:

- Shelf registration statements (paragraphs .08 and .48)
- Independence (paragraphs .13 and .36 and examples A and K)
- Compliance with SEC requirements (paragraph .15)
- Accountants' reports (paragraph .18 and footnotes 21 and 23)
- Pro forma financial information (paragraph .19g and example L)
- Comments on unaudited condensed interim financial statements that are not included in the registration statement (paragraph .24)
- Comments on subsequent changes and decreases (paragraph .31)
- Tables, statistics, and other financial information (paragraph .43 and example J)

This section also includes certain minor revisions, such as to references to SEC regulations; the paragraphs have also been renumbered.

prospectus in reliance on their audit report and their consent.¹ The accountants' reasonable investigation must be premised upon an audit; it cannot be accomplished short of an audit. What constitutes a reasonable investigation of unaudited financial information sufficient to satisfy an underwriter's purposes has never been authoritatively established. Consequently, only the underwriter can determine what is sufficient for his purposes. Accountants will normally be willing to assist the underwriter, but the assistance accountants can provide by way of comfort letters is subject to limitations. One limitation is that an independent accountant can properly comment in his professional capacity only on matters to which his professional expertise is substantially relevant. Another limitation is that procedures short of an audit, such as those contemplated in a comfort letter, provide the accountant with a basis for expressing, at the most, negative assurance.² Such limited procedures may bring to the accountant's attention significant matters affecting the financial information, but they do not provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit. Accordingly, there is necessarily a risk that the conditions or matters about which the accountant has provided negative assurance of their absence may prove to have existed.

.03 This section deals with several different kinds of matters. First, in a number of areas involving professional standards, it states whether or not it is proper for independent certified public accountants acting in their professional capacity to comment on specified kinds of matters, and, if so, what the form of comment should be. Second, suggestions of a practical nature are offered on such matters as forms of comfort letters suitable to various circumstances, the way in which a particular form of letter may be agreed upon, the dating of letters, and what steps may be taken when information that may require special mention in a letter comes to the accountants' attention.³ Third, ways are suggested to reduce or avoid the uncertainties described in the preceding paragraph regarding the nature and extent of accountants' responsibilities in connection with a comfort letter. In regard to this and other points not involving professional standards, where the recommendations are intended to reduce risks of misunderstanding, accountants requested to follow a course other than that recommended would do well to consult their counsel.

¹ See section 711, *Filings Under Federal Securities Statutes*, for a discussion of certain responsibilities of accountants resulting from inclusion of their reports in registration statements.

² Negative assurance consists of a statement by accountants that, as a result of specified procedures, nothing came to their attention that caused them to believe that specified matters do not meet a specified standard (for example, that unaudited financial statements or unaudited condensed financial statements are not in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited financial statements).

³ It is important to note that although the illustrations in this section describe procedures that are frequently followed by accountants as a basis for their comments in comfort letters, it does not prescribe such procedures.

.04 Comfort letters are not required under the Act, and copies are not filed with the SEC. It is nonetheless a common condition of an underwriting agreement in connection with the offering for sale of securities registered with the SEC under the Act that the accountants are to furnish a comfort letter. Some underwriters do not make the receipt of a comfort letter a condition of the underwriting agreement but nevertheless ask for such a letter.⁴

.05 The accountants should suggest to the underwriter that they meet together with the client to discuss the procedures to be followed in connection with a comfort letter; in this connection, the accountants may describe procedures frequently followed (see examples included at the end of this section, paragraphs .48 through .60). Because of the accountants' knowledge of the client, such a meeting may substantially assist the underwriter in reaching his decision about the procedures to be followed by the accountants. However, it is still advisable to accompany any discussion of procedures with a clear statement that the accountants cannot furnish any assurance regarding the sufficiency of the procedures for the underwriter's purposes, and it is advisable for the comfort letter to contain a statement to this effect. An appropriate way of expressing this is shown in numbered paragraph 4 of example A.

.06 Comfort letters will generally refer to one or more of the following subjects:

- a. The independence of the accountants
- b. Compliance in form in all material respects of the audited financial statements and schedules included in the registration statement with the applicable accounting requirements of the Act and the related published rules and regulations
- c. Unaudited financial statements, condensed interim financial statements, capsule information, or pro forma financial information included in the registration statement
- d. Changes in selected financial statement items during a period subsequent to the date and period of the latest financial statements included in the registration statement
- e. Tables, statistics, and other financial information included in the registration statement⁵

These matters are discussed in greater detail below and are illustrated in the examples included at the end of this section. Matters dealt with in a

⁴ Except where the context otherwise requires, the word *underwriter*, as used in this section, refers to the managing, or lead, underwriter, who typically negotiates the underwriting agreement for a group of underwriters whose exact composition is not determined until shortly before a registration statement becomes effective. In competitive bidding situations where legal counsel for the underwriters acts as the underwriters' representative prior to the opening and acceptance of the bid, the accountants should carry out the discussions and other communications contemplated by this section with the legal counsel until the underwriter is selected.

⁵ Financial information included in a registration statement also includes information incorporated in the registration statement by reference.

particular letter usually are limited to ones specified in the underwriting agreement.

.07 Because the underwriter will expect the accountants to furnish a comfort letter of a scope to be specified in the underwriting agreement, the client and the underwriter, when they have tentatively agreed upon a draft of the agreement, are well advised to furnish a copy of it to the accountants so that the latter can indicate whether they will be able to furnish a letter in acceptable form. A desirable practice is for the accountants, promptly after they have received the draft of the agreement (or have been informed that a letter covering specified matters, although not a condition of the agreement, will nonetheless be requested), to prepare a draft of the form of letter that they expect to furnish. To the extent possible, the draft should deal with all matters to be covered in the exact terms to be used in the final letter (subject, of course, to the understanding that the comments in the final letter cannot be determined until the procedures underlying it have been performed). The draft letter should be identified as a draft in order to avoid giving the impression that the procedures described therein have been performed. This practice of furnishing a draft letter at an early point permits the accountants to make clear to the client and the underwriter what they may expect the accountants to furnish and gives the client and the underwriter an opportunity to change the proposed underwriting agreement if they so desire. The underwriter thus furnished with a draft letter is afforded the opportunity to discuss further with the accountants the procedures that the accountants have indicated they expect to follow and to request any additional procedures that the underwriter may desire. If the additional procedures pertain to matters to which the accountants' professional competence is relevant, the accountants would ordinarily be willing to perform them, and it is desirable for them to furnish the underwriter with an appropriately revised draft letter. The accountants may reasonably assume that the underwriter, by indicating his acceptance of the draft comfort letter, and subsequently, by his acceptance of the letter in final form, considers the procedures described sufficient for his purposes. It is important, therefore, that the procedures to be followed by the accountants be clearly set out in the comfort letter, in both draft and final form, so that there will be no misunderstanding about the basis upon which the accountants' comments have been made and so that the underwriter can decide whether the procedures performed are sufficient for his purposes. For reasons explained in paragraph .02, statements or implications that the accountants are carrying out such procedures as they consider necessary should be avoided since this may lead to misunderstanding about the responsibility for the sufficiency of the procedures for the underwriter's purposes. The following is a suggested form of legend that may be placed on the draft letter for identification and explanation of its purposes and limitations.

This draft is furnished solely for the purpose of indicating the form of letter that we would expect to be able to furnish [name of underwriter] in

response to their request, the matters expected to be covered in the letter, and the nature of the procedures that we would expect to carry out with respect to such matters. Based on our discussions with [name of underwriter], it is our understanding that the procedures outlined in this draft letter are those they wish us to follow.⁶ Unless [name of underwriter] informs us otherwise, we shall assume that there are no additional procedures they wish us to follow. The text of the letter itself will depend, of course, upon the results of the procedures, which we would not expect to complete until shortly before the letter is given and in no event before the cutoff date indicated therein.

.08 Regulations under the Act permit, in certain circumstances, companies to register a designated amount of securities for continuous or delayed offerings during an extended period by filing one "shelf" registration statement. At the effective date of a shelf registration statement, the registrant may not have selected an underwriter (see footnote 4). A client or the legal counsel designated to represent the underwriting group might, however, ask the accountants to issue a comfort letter at the effective date of a shelf registration statement to expedite the due diligence activities of the underwriter when he is subsequently designated and to avoid later corrections of financial information included in an effective prospectus. However, as stated in paragraph .02, only the underwriter can determine the procedures that will be sufficient for his purposes. In these circumstances, therefore, the accountants should not agree to furnish a comfort letter addressed to the client or legal counsel or to a nonspecific addressee such as to "any or all underwriters to be selected."⁷ The accountants may agree to furnish the client or the legal counsel for the underwriting group with a draft comfort letter describing the procedures that the accountants have performed and the comments the accountants are willing to express as a result of those procedures. The draft comfort letter should include a legend describing its purpose and limitations such as the following.

This draft describes the procedures that we have performed and represents a letter we would be prepared to sign as of the effective date of the registration statement if the managing underwriter had been chosen at that date and requested such a letter. Based on our discussions with [name of client or legal counsel], the procedures set forth are similar to those that experience indicates underwriters often request in such circumstances. The text of the final letter will depend, of course, on whether the managing underwriter who

⁶ In the absence of any discussions with the underwriter, the accountants should outline in the draft letter those procedures specified in the underwriting agreement that they are willing to perform. In that event, this sentence should be revised as follows: "In the absence of any discussions with [name of underwriter], we have set out in this draft letter those procedures referred to in the draft underwriting agreement (of which we have been furnished a copy) that we are willing to follow."

⁷ This section is not intended to preclude accountants from providing to the client's board of directors, when appropriate, a letter addressed to the board of directors similar in content to a comfort letter. For example, see the auditing interpretation, "Letters to Directors Relating to Annual Reports on Form 10-K" (April 1981). (Section 9634.01—.09.)

is selected requests that other procedures be performed to meet his needs and whether the managing underwriter requests that any of the procedures be updated to the date of issuance of the signed letter.

A signed comfort letter may be issued to the underwriter selected for the portion of the issue then being offered when the underwriting agreement for an offering is signed and at each closing date.

Dating

.09 The letter ordinarily is dated at or shortly before the *closing date* (the date on which the issuer or selling security holder delivers the securities to the underwriter in exchange for the proceeds of the offering). The underwriting agreement ordinarily specifies the date, often referred to as the *cutoff date*, to which the letter is to relate (for example, a date five business days before the date of the letter); the accountants should see that the cutoff date will not place an unreasonable burden on them. The letter should state that the inquiries and other procedures carried out in connection with the letter did not cover the period from the cutoff date to the date of the letter.

.10 Letters may also be dated at or shortly before the *effective date* (the date on which the registration statement becomes effective); and, on rare occasions, letters have been requested to be dated at or shortly before the *filing date* (the date on which the registration statement is first filed with the SEC). If more than one letter is requested, it will be necessary to carry out the specified procedures and inquiries as of the cutoff date for each letter. Although comments contained in an earlier letter may on occasion conveniently be incorporated by reference in a subsequent letter (see example C), any subsequent letter should relate only to information in the registration statement as most recently amended.

Addressee

.11 Because the letter is a result of the underwriter's request, many accountants address the letter only to the underwriter, with a copy furnished to the client. When this is done, the appropriate addressee is the underwriter who has negotiated the underwriting agreement with the client, and with whom the accountants will deal in discussions regarding the scope and sufficiency of the letter, rather than the group of underwriters for whom that underwriter acts as representative.⁸ Some accountants address the letter instead to the client, or to both the client and the underwriter. If the accountants are requested to address the letter to any person other than the underwriter or the client, they should consider consulting their legal counsel.

⁸ An appropriate form of address for this purpose is "XYZ & Company, as Representative of the Several Underwriters."

Introductory Paragraph

.12 It is desirable to include an introductory paragraph substantially as follows:

We have examined the [identify the financial statements and schedules examined] included [incorporated by reference] in the registration statement (no. 2-00000) on Form _____ filed by the company under the Securities Act of 1933 (the Act); our reports with respect thereto are also included [incorporated by reference] in that registration statement. The registration statement, as amended as of _____, is herein referred to as the registration statement.

Independence

.13 It is customary for the underwriting agreement to provide for the accountants to make a statement concerning their independence in the letter. This may be done substantially as follows:

We are independent certified public accountants with respect to The Blank Company, Inc., within the meaning of the Act and the applicable published rules and regulations thereunder.

Regulation S-K requires disclosure in the prospectus and registration statement of interests of named experts (including independent accountants) in the registrant. Regulation S-X precludes an accountant who reports on financial statements in a registration statement from having interests of the type requiring disclosure in the prospectus or registration statement. Therefore, if an accountant makes a statement in a comfort letter that he is independent within the meaning of the Act and the applicable published rules and regulations thereunder, any additional comments on independence would be unnecessary. (See paragraph .36 regarding instances when the accountants' client is not the registrant.)

Compliance With SEC Requirements

.14 The accountants may be requested to express an opinion concerning compliance as to form of the financial statements covered by their report with the pertinent published accounting requirements of the SEC.⁹ This may be done substantially as follows:

In our opinion [include phrase, "except as disclosed in the registration statement," if applicable], the [identify the financial statements and schedules examined] examined by us and included or incorporated by reference in the registration statement comply in form in all material

⁹ The word *published* is used because accountants should not be expected to be familiar with, or express assurances as to compliance with, informal requirements that have not been published by the SEC but that may be applied by the SEC staff.

respects with the applicable accounting requirements of the Act and the related published rules and regulations.¹⁰

If there is a material departure from the pertinent published requirements, the departure should be disclosed in the letter. Normally, representatives of the SEC will have agreed to such a departure; when this occurs, the agreement should be mentioned in the comfort letter.¹¹ An appropriate manner of doing this is shown in example D.

.15 Accountants may comment on compliance as to form with requirements under published SEC rules and regulations only with respect to those rules and regulations applicable to the form and content of financial statements and schedules. Accountants should not comment on compliance as to form of other information included in the registration statement, for example, the ratio of earnings to fixed charges, selected financial data, executive compensation, and industry statistical data. (See paragraph .20 regarding unaudited condensed interim financial statements and paragraph .19g regarding pro forma financial information.)

Accountants' Reports

.16 Underwriters occasionally request the accountants to repeat in the comfort letter their opinion on the audited financial statements included in the registration statement. Because of the special significance of the date of an accountant's report, the accountants should not repeat their opinion.¹² Underwriters sometimes request negative assurance regarding the accountants' opinion. Because accountants have a statutory responsibility with respect to their opinion as of the effective date, and because the additional significance, if any, of negative assurance is unclear and such assurance may therefore give rise to misunderstanding, accountants should not give such negative assurance. Also, the accountants should not give negative assurance with respect to financial statements and schedules that

¹⁰ Certain financial statements may be incorporated in a registration statement under the Securities Act of 1933 by reference to filings under the Securities Exchange Act of 1934 (the 1934 Act). In those circumstances, the accountants may refer to compliance in form in all material respects of the audited financial statements and schedules included or incorporated by reference in the registration statement with the applicable accounting requirements of the 1934 Act and the related published rules and regulations (see example K). However, the accountants should not refer to compliance with the provisions of the 1934 Act regarding internal accounting control. See the auditing interpretation, "Compliance with the Foreign Corrupt Practices Act of 1977" (October 1978). (Section 9642.10—.13.)

¹¹ Departures from published SEC requirements that require mention in a comfort letter ordinarily do not affect fair presentation in conformity with generally accepted accounting principles; however, if they do, the accountants will of course take cognizance of these departures in expressing their opinion and in consenting to the use of their report in the registration statement. If departures from published SEC requirements that require mention in a comfort letter either are not disclosed in the registration statement or have not been agreed to by representatives of the SEC, the accountants should consider carefully the issuance of a consent to the use of their report in the registration statement.

¹² See section 530.03—.08.

have been examined and are reported on in the registration statement by other accountants.

.17 An underwriter may also request the accountants to comment in their comfort letter on (a) unaudited interim financial information required by item 302(a) of SEC Regulation S-K, to which section 722 relates, or (b) required supplementary information, to which section 553 relates. Sections 553 and 722 provide that the accountant should expand his standard report on the audited financial statements to refer to such information when the scope of his procedures with regard to the information was restricted or when the information appears not to be presented in conformity with generally accepted accounting principles or (for required supplementary information) applicable guidelines. Such expansions of the accountants' standard report in the registration statement would ordinarily be referred to in the opening paragraph of the comfort letter (see paragraphs .32 through .35). Additional comments on such unaudited information are therefore unnecessary. However, if the underwriter requests the accountants to perform procedures with regard to such information in addition to the procedures performed in connection with the audit as prescribed by sections 553 and 722, the accountants may do so and report their findings.

.18 The accountants may refer in the introductory paragraphs of the comfort letter to the fact that they have issued reports on—

- a. Condensed financial statements that are derived from audited financial statements (see section 552).
- b. Selected financial data (see section 552).
- c. A review of interim financial information (see section 722).
- d. Pro forma financial information (or a financial forecast filed in lieu of a pro forma condensed income statement).

Such a reference should be to the accountants' reports that were previously issued, and if not included in the registration statement, the reports may be attached to the comfort letter. In referring to previously issued reports, the accountants should not repeat their reports in the comfort letter or otherwise imply that they are reporting as of the date of the comfort letter or that they assume responsibility for the sufficiency of the procedures for the underwriter's purposes. However, for certain information on which they have reported, the accountants may agree to comment regarding compliance with published SEC requirements (see paragraph .15).

Unaudited Condensed Interim Financial Statements, Capsule Information, and Subsequent Changes

In General

.19 Comments included in the letter will often concern (1) unaudited condensed interim financial statements included in the registration statement

(see paragraphs .20 and .21),¹³ (2) capsule information (see paragraphs .22 through .24), (3) changes in capital stock and long-term debt and decreases in other specified financial statement items (see paragraphs .25 through .30), and (4) pro forma financial information. In commenting on these matters, the following guides are important:

- a. Any statements by the accountants with respect to unaudited condensed interim financial statements, capsule information, and subsequent changes or decreases should be limited to negative assurance. An appropriate manner of expressing the comments is shown in numbered paragraph 5 of example A.
- b. As explained in paragraph .07, the agreed-upon procedures performed by the accountants should be set forth in the letter. Such procedures are generally described along the lines of numbered paragraph 4 of example A.
- c. To avoid any misunderstanding about the responsibility for the sufficiency of the agreed-upon procedures for the underwriter's purposes, the accountants should not make any statements or imply that they have applied procedures that they have determined to be necessary or sufficient for the underwriter's purposes. In this respect, the underwriter may request the accountants to perform procedures similar to those in section 722.06. However, for the accountants to include such procedures in their letter, the underwriter would have to provide sufficiently specific criteria so that there is no implication that the responsibility for the sufficiency of the agreed-upon procedures has been assumed by the accountants. For example, if the underwriter requests the accountants to apply analytical review procedures and specifies items of financial information to be reviewed and the materiality level for changes in those items that would necessitate further inquiry by the accountants, the accountants may refer to those procedures in their letter. Descriptions of procedures in the comfort letter should include descriptions of the criteria specified by the underwriter.
- d. Terms of uncertain meaning, such as *general review*, *limited review*, *check*, or *test*, should not be used in describing the work, unless the procedures comprehended by the terms are described in the comfort letter.
- e. The letter should specifically identify any unaudited condensed interim financial statements and should state that the accountants have not examined the condensed interim financial statements in accordance with generally accepted auditing standards and do not express an

¹³ The SEC requirements specify condensed financial statements. However, the guidance in paragraphs .19 through .21 also applies to complete financial statements. For purposes of this section, interim financial statements may be for a twelve-month period ending on a date other than the entity's normal year-end.

opinion concerning them. An appropriate manner of making this clear is shown in numbered paragraph 3 of example A (see also paragraph .21).

- f. The accountants should not give negative assurance with respect to unaudited condensed interim financial statements, capsule information, or changes or decreases unless they have obtained knowledge of the client's accounting and financial reporting practices and its system of internal accounting control relating to the preparation of financial statements. An understanding of the client's practices in preparing its most recent annual financial statements provides a practical basis for the accountants' inquiries or procedures. Ordinarily, accountants obtain such an understanding in auditing the client's financial statements for one or more annual periods. However, if for whatever reason the accountants have not conducted such an audit, the need for an understanding of the client's accounting and financial reporting practices and its system of internal accounting control is not diminished, and the accountants should consider whether, under the particular circumstances, they can acquire sufficient knowledge of these matters to perform the inquiries and procedures requested by the underwriter.
- g. The accountants should not give negative assurance on the application of pro forma adjustments to historical financial statements, the compilation of pro forma financial information, or whether the pro forma financial information complies as to form with published SEC rules and regulations unless (1) they have made an examination of the historical financial statements of the entity (or, in the case of business combinations, of a significant constituent part of the combined entity) (a) for the period presented or (b) in the case of interim periods for the latest fiscal period that includes or precedes the interim period, or (2) they have otherwise obtained knowledge of the entity's accounting and financial reporting practices and its system of internal accounting control as provided for in f above.¹⁴ (See example L.)
- h. The procedures followed with respect to interim periods may not disclose changes in capital stock or long-term debt or decreases in the specified financial statement items, inconsistencies in the application of generally accepted accounting principles, instances of noncompliance in form with accounting requirements of the SEC, or other matters about which negative assurance is requested. An

¹⁴ Regulation S-X permits a financial forecast to be filed in lieu of the required pro forma condensed income statement. Because of the unique responsibilities of the accountants regarding financial forecasts, the accountants should not include in a comfort letter any description of procedures or any assurance based on those procedures regarding a financial forecast. (See paragraph .18 regarding reference in a comfort letter to an accountant's report on a financial forecast.) This prohibition also applies to other prospective financial information included in the registration statement.

appropriate manner of making this clear is shown in the last three sentences in paragraph 4 of example A.

- i. The working papers relating to comfort letters should be prepared in such a manner that they constitute an adequate record of what has been done.

Unaudited Condensed Interim Financial Statements

.20 Comments in the comfort letter concerning the unaudited condensed interim financial statements appearing in the registration statement should always be made in the form of negative assurance.¹⁵ Frequently, such comments relate to (a) conformity with generally accepted accounting principles, (b) substantial consistency with the audited financial statements included in the registration statement, and (c) compliance in form with applicable SEC accounting requirements. An appropriate manner of expressing the comments is shown in numbered paragraph 5a of example A.

.21 When the most recent figures included in a condensed statement of income are for a period of less than one year, the SEC requires that comparative figures be shown for the corresponding short period of the preceding year. The condensed financial statements for the latest interim period and the preceding year are ordinarily unaudited. In these circumstances, the unaudited status of the condensed financial statements should be made clear in the comfort letter (see numbered paragraph 3 of example A and paragraph .19e).

Capsule Information

.22 In some registration statements the information shown in the audited financial statements or unaudited condensed interim financial statements is supplemented by unaudited summarized interim information for subsequent periods (commonly called *capsule information*). This capsule information (either in narrative or tabular form) is often provided for the most recent interim period and for the corresponding period of the prior year. With regard to selected capsule information, the accountants—

- a. May give negative assurance in regard to conformity with generally accepted accounting principles and may refer to whether the dollar amounts were determined on a basis substantially consistent with that of the corresponding amounts in the audited financial statements if the selected capsule information is presented in accordance with the minimum disclosure requirements of APB Opinion No. 28, paragraph 30 [AC section I73.146], or
- b. May refer only to whether the dollar amounts were determined on a basis substantially consistent with that of the corresponding amounts in the audited financial statements if the selected capsule information

¹⁵ See section 504, *Association With Financial Statements*, paragraphs .18 through .20.

is more limited than the minimum disclosures described in APB Opinion No. 28, paragraph 30 [AC section I73.146] (see example E).

.23 The underwriter occasionally asks the accountants to give negative assurance with respect to the unaudited interim financial statements or unaudited condensed interim financial statements (see the interim financial information requirements of Regulation S-X) that underlie the capsule information and asks the accountants to state that the capsule information agrees with amounts set forth in such statements. Paragraphs 4b and 5b in example E provide an example of the accountants' comments in these circumstances.

.24 The underwriter might ask the accountants to give negative assurance with respect to unaudited condensed interim financial statements for a period ending after the latest financial statements included in the registration statement. In those cases, the unaudited condensed interim financial statements (see the interim financial information requirements of Regulation S-X) should be attached to the comfort letter. If the client requests, the unaudited condensed interim financial statements may be attached only to the copy of the letter intended for the managing underwriter.

Subsequent Changes

.25 Comments regarding subsequent changes also should be in the form of negative assurance. They should not relate to "adverse changes" since, despite long use, that term has not acquired any defined or clearly understood meaning in an accounting sense. In fact, underwriters occasionally may have misinterpreted that term as encompassing judgments and conclusions not contemplated by the accountants. For example, there has been no agreement among accountants, clients, and underwriters regarding whether the term relates only to absolute changes or also includes trends in amounts or ratios. Further, there are differences of view regarding whether an adverse change in results of operations is indicated solely by a decrease in net income or whether it also encompasses changes in sales, cost of sales, and other factors that separately or together might indicate the beginning or accentuation of an adverse trend. Also, the term has sometimes been construed as contemplating comments by accountants regarding matters to which their professional competence has little relevance, such as evaluating whether certain types of expenses that may decrease current income but are designed to increase future income (for example, research and development costs, major advertising campaigns, and systems installations) are adverse or not. In order that comments on subsequent changes be unambiguous and their determination be within the professional competence of accountants, the comments should not relate to adverse changes but should ordinarily relate to whether there has been any change in capital stock or long-term debt or "decreases" in other specified financial statement items during a period known as the *change period* (see paragraph .27). Usually these items would include the amounts of net current assets, net assets (stockholders' equity), and net sales and the total and/or per-share amounts of income before extraordinary items and of net income. An appropriate manner of expressing

the comments is shown (a) in numbered paragraph 5b of example A if there has been no decrease and (b) in example F if there has been a decrease.

.26 Matters to be covered by the letter should be made clear in the meetings with the underwriter and should be contemplated by the underwriting agreement and in the draft comfort letter. Since there is no way of anticipating other matters that would be of interest to an underwriter, accountants should not make a general statement in comfort letters that, as a result of carrying out the specified procedures, nothing else has come to their attention that would be of interest to the underwriter.

.27 In the context of a comfort letter, a decrease occurs when the amount of a financial statement item at the cutoff date or for the change period (as if financial statements and their notes had been prepared at that date and for that period) is less than the amount of the same item at a specified earlier date or for a specified earlier period. With respect to the items mentioned in paragraph .25, the term *decrease* means (a) any combination of changes in amounts of current assets and current liabilities that results in decreased net current assets, (b) any combination of changes in amounts of assets and liabilities that results in decreased net assets, (c) decreased net sales, and (d) any combination of changes in amounts of sales and expenses and/or outstanding shares that results in decreased total and/or per-share amounts of income before extraordinary items and of net income (including, in each instance, a greater loss or other negative amount). The change period for which the accountants give negative assurance in the comfort letter ends on the cutoff date (see paragraph .09) and ordinarily begins (a) for balance sheet items, immediately after the date of the latest balance sheet in the registration statement, and (b) for income statement items, immediately after the latest period for which such items are presented in the registration statement. The comparison relates to the entire period and not to portions thereof. A decrease during one part of a period may be offset by an equal or larger increase in another part of the period; however, because there was no decrease for the period as a whole, the comfort letter would not report the decrease occurring during one part of the period (see, however, paragraph .47).

.28 Underwriters occasionally request that the change period begin immediately after the date of the latest audited balance sheet (ordinarily also the closing date of the latest audited statement of income) in the registration statement, even though the registration statement includes a more recent unaudited condensed balance sheet and condensed statement of income. The use of the earlier date may defeat the underwriter's purpose since it is possible that an increase in one of the items referred to in paragraph .25 occurring between the dates of the latest audited and unaudited balance sheets included in the registration statement might more than offset a decrease occurring after the latter date. A similar situation might arise in the comparison of income statement items. In these circumstances, the decrease occurring after the date of the latest unaudited condensed interim financial statements included in the registration statement would not be reported in the comfort

letter. It is desirable for the accountants to explain the foregoing considerations to the underwriter; however, if the underwriter nonetheless requests the use of a change period or periods other than those described in paragraph .27, the accountants may use the period or periods requested.

.29 The underwriting agreement usually specifies the dates and periods with which data at the cutoff date and for the change period are to be compared. For balance sheet items the comparison date is normally that of the latest balance sheet included in the registration statement (that is, immediately prior to the beginning of the change period). For income statement items the comparison period or periods might be one or more of the following: (a) the corresponding period of the preceding year, (b) a period of corresponding length immediately preceding the change period, (c) a proportionate part of the preceding fiscal year, or (d) any other period of corresponding length chosen by the underwriter. Whether or not specified in the underwriting agreement, the date and period used in comparison should be identified in the comfort letter in both draft and final form so that there is no misunderstanding about the matters being compared and so that the underwriter can determine whether the comparison period is suitable for his purposes.

.30 In addition to making the comparisons indicated above using the financial statements made available to them, the accountants will ordinarily be requested to read minutes and make inquiries of company officials relating to the whole of the change period.¹⁶ For the period between the date of the latest financial statements made available and the cutoff date, the accountants must necessarily base their comments solely on the limited procedures actually performed with respect to that period (which in most cases will be limited to the reading of minutes and the inquiries of company officials referred to in the preceding sentence), and their comfort letter should make this clear (see numbered paragraph 6 of example A).

Disclosure in Registration Statement

.31 Comments on the occurrence of changes in capital stock or long-term debt and decreases in other specified financial statement items are limited to changes or decreases not disclosed in the registration statement. Accordingly, the phrase "except for changes or decreases that the registration statement discloses have occurred or may occur" should be included in the letter when it has come to the accountants' attention that a change or decrease has occurred during the change period, and the change or decrease is disclosed in the registration statement. The above phrase need not be included in the letter when no changes or decreases in the specified financial statement items are disclosed in the registration statement.

¹⁶ The answers to these inquiries generally should be supported by appropriate written representations of the company officials.

Effect of Qualified Opinion

.32 The foregoing discussion contemplates that the accountants' opinion on the financial statements and schedules in the registration statement is unqualified. This usually is the case. Except in extraordinary circumstances, the requirements of the SEC do not permit a registration statement to become effective when the accountants' opinion is qualified in regard to the scope of their examination or the accounting principles reflected in the financial statements and schedules. However, such circumstances do occasionally arise, and although the SEC may permit the registration statement to become effective even though the opinion is qualified, the accountants may not be in a position to give an unqualified opinion that the financial statements in the registration statement comply in form in all material respects with the published rules and regulations of the SEC under the Act (see paragraph .14).

.33 The SEC ordinarily will accept a "subject to" type of qualification in the accountants' opinion when there is uncertainty about the outcome of controversial matters, such as litigation, renegotiation of contracts, disputes concerning income taxes, the proceedings of rate-regulatory commissions, or other matters whose outcomes are not susceptible of reasonable estimation but that might have a material effect on the financial statements.

.34 If the opinion is qualified, the qualification should be referred to in the opening paragraph of the comfort letter by saying, for example, "our reports (which contain a qualification as set forth therein) with respect thereto are also included in the registration statement."¹⁷

.35 If the letter includes negative assurance with respect to subsequent unaudited condensed interim financial statements included in the registration statement or with respect to an absence of specified subsequent changes or decreases, the effect thereon of the subject matter of the qualification should also be considered. An illustration of how this type of situation may be dealt with is shown in example G.

Other Accountants

.36 Comfort letters are occasionally requested from more than one accountant (for example, in connection with registration statements to be used in the subsequent sale of shares issued in recently effected mergers). In these circumstances, each accountant must, of course, be sure he is independent within the meaning of the Act and the applicable published rules and regulations thereunder. In connection with opinions expressed prior to the acquisitions, the accountants for previously nonaffiliated companies recently acquired by the registrant would not be required to have been independent

¹⁷ The accountants may also refer in the opening paragraph to expansions of their report that do not affect their opinion, for example, expansions of their report regarding interim financial information accompanying or included in the notes to audited financial statements (see section 722, *Review of Interim Financial Information*, paragraphs .29 and .30) or required supplementary information described in section 553, *Supplementary Information Required by the Financial Accounting Standards Board* (see section 553, paragraphs .08 through .10). See paragraph .17 herein.

with respect to the company whose shares are being registered. In such a case, the accountants should modify the wording suggested in paragraph .13 and make a statement regarding their independence along the following lines.

As of [insert date of the accountants' most recent report on the financial statements of their client] and during the period covered by the financial statements on which we reported, we were independent certified public accountants with respect to [insert the name of their client] within the meaning of the Act and the applicable published rules and regulations thereunder.

.37 There may be situations in which more than one accountant is involved in the examination of the financial statements of a business and in which the reports of more than one accountant appear in the registration statement. For example, certain significant divisions, branches, or subsidiaries may be examined by other accountants. The principal accountants (those who report on the consolidated financial statements and consequently are asked to give a comfort letter with regard to information expressed on a consolidated basis) should read the letters of the other accountants reporting on significant units. Such letters should contain statements similar to those contained in the comfort letter prepared by the principal accountants, including statements about their independence. The principal accountants should state in their comfort letter that (a) reading letters of other accountants was one of the procedures followed, and (b) the procedures performed by the principal accountants (other than reading the letters of the other accountants) relate solely to (1) companies examined by the principal accountants and (2) the consolidated financial statements. An appropriate manner of expressing these comments where the letters of the other accountants do not disclose matters that affect the negative assurance given is shown in example H. If the letters of the other accountants disclose decreases in financial statement items or any other matters that affect the negative assurance that is given, the principal accountants should mention these matters in their letter. Where appropriate, the principal accountants may comment that there were no decreases in the consolidated financial statement items despite the decreases mentioned by the other auditors. In such a case, the principal accountants could give negative assurance that nothing had come to their attention regarding the consolidated financial statements as a result of the specified procedures (which, so far as the related company was concerned, consisted solely of reading the other accountants' letter) that caused them to believe that. . . .

.38 At the earliest practicable date, the client should advise any other accountants who may be involved about any letter that may be required from them and should arrange for them to receive a draft of the underwriting agreement so that they may make arrangements at an early date for the preparation of a draft of their letter (a copy of which should be furnished to the principal accountants) and for the performance of their procedures. In addition, the underwriter may desire to meet with the other accountants for the purposes discussed in paragraph .05.

.39 When a comfort letter is furnished to other accountants, it should be addressed in accordance with paragraph .11, and copies should be furnished to the principal accountants and their client. The letter should contain a concluding paragraph similar to the example in paragraph .46.

Tables, Statistics, and Other Financial Information

.40 The underwriting agreement sometimes calls for a comfort letter that includes comments on tables, statistics, and other financial information appearing in the registration statement.

.41 The accountants should refrain from commenting on matters to which their competence as independent public accountants has little relevance. Accordingly, except as indicated in the next sentence, they should comment only with respect to information (a) that is expressed in dollars (or percentages derived from such dollar amounts) and has been obtained from accounting records that are subject to the internal controls of the company's accounting system or (b) that has been derived directly from such accounting records by analysis or computation. The accountants may also comment on quantitative information that has been obtained from an accounting record if the information is of a type that is subject to the same controls as the dollar amounts. Accountants should not comment on matters involving primarily the exercise of business judgment of management. For example, changes between periods in gross profit ratios or net income may be caused by factors that are not necessarily within the expertise of accountants. The accountants should not comment on matters merely because they happen to be present and are capable of reading, counting, measuring, or performing other functions that might be applicable. Examples of matters that, unless subjected to the internal controls of the formal accounting system (which is not ordinarily the case), should not be commented on by the accountants include square footage of facilities, number of employees (except as related to a given payroll period), and backlog information. The accountants should not comment on tables, statistics, and other financial information relating to an unaudited period (a) unless they have made an examination of the client's financial statements for a period including or immediately prior to the unaudited period or have completed an examination for a later period, or (b) unless they have otherwise obtained knowledge of the client's accounting and financial reporting practices and its system of internal accounting control as provided for in paragraph .19f herein.

.42 As with comments relating to financial statement information, it is important that the procedures followed by the accountants with respect to other information be clearly set out in the comfort letter, in both draft and final form, so that there will be no misunderstanding about the basis of comments on the information. Further, so that there will be no implication that the accountants are furnishing any assurance with respect to the sufficiency of the procedures for the underwriter's intended purpose, it is advisable for the comfort letter to contain a statement to this effect. An

appropriate way of expressing this is shown in numbered paragraph 10 of example I (see also paragraph .07 of this section).

.43 In order to avoid ambiguity, the specific information commented on in the letter should be identified by reference to specific captions, tables, page numbers, or specific paragraphs or sentences. Descriptions of the procedures followed and the findings may be stated individually for each item of specific information commented on. Alternatively, some or all of the descriptions may be grouped or summarized if the procedures and findings are adequately described, if the descriptions do not imply that the accountants assume responsibility for the adequacy of the procedures, and if it is unlikely that the applicability of the descriptions to items in the registration statement will be misunderstood.

.44 Comments in the comfort letter concerning tables, statistics, and other financial information included in the registration statement should be made in the form of a description of the procedures followed, the findings (ordinarily expressed in terms of agreement between items compared), and in some cases, as described below, statements with respect to the acceptability of methods of allocation used in deriving the figures commented upon. Whether comments upon the allocation of income or expense items between such categories as military and commercial sales may appropriately be made will depend upon the extent to which such allocation is made in, or can be derived directly by analysis or computation from, the client's accounting records. In any event, such comments, if made, should make clear that such allocations are to a substantial extent arbitrary, that the method of allocation used is not the only acceptable one, and that other acceptable methods of allocation might produce significantly different results. Furthermore, no comments should be made regarding segment information (or the appropriateness of allocations made to derive segment information) included in financial statements, since the auditor's report encompasses that information (see section 435).¹⁸ Appropriate ways of expressing comments on tables, statistics, and other financial information are shown in example I and example J.

.45 In comments concerning tables, statistics, and other financial information, the expression *presents fairly* (or a variation of it) should not be used. That expression, when used by independent certified public accountants, ordinarily relates to presentations of financial statements and should not be used in commenting on other types of information. Except with respect to requirements for financial statements, the question of what constitutes appropriate information for compliance with the requirements of a particular item of the registration statement form (for example, whether particular employee benefits constitute executive compensation as defined by SEC regulations) is a matter of legal interpretation outside the competence of the accountants. Consequently, the letter should state that the accountants make

¹⁸ See paragraph .17 herein regarding requests by an underwriter for comments on interim financial information required by item 302(a) of SEC Regulation S-K and required supplementary information described in section 553.

no representations regarding any matter of legal interpretation. Since the accountants will not be in a position to make any representations about the completeness or adequacy of disclosure or about the adequacy of the procedures followed, the letter should so state. It should point out as well that such procedures would not necessarily disclose material misstatements or omissions in the information to which the comments relate. An appropriate manner of expressing the comments is shown in example I and example J.

Concluding Paragraph

.46 In order to avoid misunderstanding of the purpose and intended use of the comfort letter, it is desirable that the letter conclude with a paragraph along the following lines:

This letter is solely for the information of the addressees and to assist the underwriters¹⁹ in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including, but not limited to, the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

Miscellaneous

.47 Accountants who discover matters that may require mention in the final comfort letter but that are not mentioned in the draft letter that has been furnished to the underwriter, such as decreases or changes in specified items not disclosed in the registration statement (see paragraphs .25 and .31), will naturally want to discuss them with their client so that consideration can be given to whether disclosure should be made in the registration statement. If disclosure is not to be made, the accountants should inform the client that the matters will be mentioned in the comfort letter and should suggest that the underwriter be promptly informed. It is recommended that the accountants be present when such matters are discussed between the client and the underwriter.

Examples

.48 The contents of letters for underwriters vary, depending on the extent of the information in the registration statement and the wishes of the underwriter. This section provides examples of letters for underwriters or portions of such letters. Shelf registration statements may have several closing

¹⁹ When the letter is furnished by the accountants for a subsidiary who are not accountants for the parent company, it should include at this point the following phrase: "and for the use of the accountants for [name of issuer] in furnishing their letter for the underwriters."

dates and different underwriters. Descriptions of procedures and findings regarding interim financial statements, tables, statistics, or other financial information that is incorporated by reference from previous 1934 Act filings may have to be repeated in several comfort letters. To avoid restating these descriptions in each comfort letter, accountants may initially issue the comments in a format (such as an appendix) that can be referred to in, and attached to, subsequently issued comfort letters.

Example A: Typical Letter

.49 The following matters are covered in a typical comfort letter:

- a. A statement regarding the independence of the accountants (paragraph .13)
- b. An opinion regarding whether the audited financial statements and schedules included in the registration statement comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations (paragraphs .14 and .15).
- c. Negative assurance with respect to whether the unaudited condensed interim financial statements included in the registration statement (paragraphs .19 through .21)—
 - (i) Comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations
 - (ii) Are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited financial statements included in the registration statement
- d. Negative assurance with respect to whether, during a specified period following the date of the latest financial statements in the registration statement and prospectus, there has been any change in capital stock or long-term debt or any decrease in other specified financial statement items (paragraphs .19 and .25 through .30).

Example A is a letter covering all these items. Letters that cover some of the items may be developed by omitting inapplicable portions of example A.

Example A assumes the following circumstances.²⁰ The prospectus (part I of the registration statement) includes audited consolidated balance sheets as of December 31, 19X5 and 19X4, and audited consolidated statements of income, retained earnings, and changes in financial position for each of the three years in the period ended December 31, 19X5. Part I also includes an unaudited consolidated condensed balance sheet as of March 31, 19X6, and unaudited consolidated condensed statements of income, retained earnings, and changes in financial position for the three-month periods ended March 31, 19X6 and 19X5, which were reviewed by the independent accountants and their review report was dated May 15, 19X6. Part II of the registration

²⁰ The example includes financial statements required by SEC regulations to be included in the filing. If additional financial information is covered by the comfort letter, appropriate modifications should be made.

statement includes consolidated financial schedules for the three years ended December 31, 19X5 (audited). The effective date is June 23, 19X6. The cutoff date is June 25, 19X6, and the letter is dated June 30, 19X6.

Each of the comments in the letter is in response to a requirement of the underwriting agreement. For purposes of example A, the income statement items of the current interim period are to be compared with those of the corresponding period of the preceding year.

June 30, 19X6

[Addressee]

Dear Sirs:

We have examined the consolidated balance sheets of The Blank Company, Inc. (the company) and subsidiaries as of December 31, 19X5 and 19X4 and the consolidated statements of income, retained earnings, and changes in financial position for each of the three years in the period ended December 31, 19X5, and the related schedules all included in the registration statement (no. 2-00000) on Form S-1 filed by the company under the Securities Act of 1933 (the Act); our reports with respect thereto are also included in that registration statement. The registration statement, as amended on June 23, 19X6, is herein referred to as the registration statement.²¹

In connection with the registration statement—

1. We are independent certified public accountants with respect to The Blank Company, Inc., within the meaning of the Act and the applicable published rules and regulations thereunder.

2. In our opinion [include the phrase “except as disclosed in the registration statement,” if applicable], the consolidated financial statements and schedules examined by us and included in the registration statement comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations.

3. We have not examined any financial statements of the company as of any date or for any period subsequent to December 31, 19X5; although we have made an examination for the year ended December 31, 19X5, the purpose (and therefore the scope) of the examination was to enable us to express our opinion on the consolidated financial statements as of December 31, 19X5, and for the year then ended, but not on the financial statements for any interim period within that year. Therefore, we are unable to and do

²¹ As described in paragraph .18, the accountants may refer in the introductory paragraphs to the fact that they have issued reports on other financial information. For example, if the accountants refer to the fact that a review of interim financial information had been performed, an additional introductory paragraph, such as the following, may be added.

Also, we have made a review of the unaudited consolidated condensed financial statements for the three-month periods ended March 31, 19X6 and 19X5, as indicated in our report dated May 15, 19X6, which is included [incorporated by reference] in the registration statement.

not express any opinion on the unaudited consolidated condensed balance sheet as of March 31, 19X6, and unaudited consolidated condensed statements of income, retained earnings, and changes in financial position for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement, or on the financial position, results of operations, or changes in financial position as of any date or for any period subsequent to December 31, 19X5.

4. For purposes of this letter we have read the 19X6 minutes of meetings of the stockholders, the board of directors, and [include other appropriate committees, if any] of the company and its subsidiaries as set forth in the minute books at June 25, 19X6, officials of the company having advised us that the minutes of all such meetings through that date were set forth therein; and we have carried out other procedures to June 25, 19X6 (our work did not extend to the period from June 26, 19X6, to June 30, 19X6, inclusive), as follows:

- a. With respect to the three-month periods ended March 31, 19X6 and 19X5, we have—
 - (i) Read the unaudited consolidated condensed balance sheet as of March 31, 19X6, and unaudited consolidated condensed statements of income, retained earnings, and changes in financial position for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement; and
 - (ii) Made inquiries of certain officials of the company who have responsibility for financial and accounting matters regarding (1) whether the unaudited consolidated condensed financial statements referred to in a(i) comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations and (2) whether those unaudited consolidated condensed financial statements are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements included in the registration statement.
- b. With respect to the period from April 1, 19X6, to May 31, 19X6, we have—
 - (i) Read the unaudited consolidated financial statements of the company and subsidiaries for April and May of both 19X5 and 19X6 furnished us by the company, officials of the company having advised us that no such financial statements as of any date or for any period subsequent to May 31, 19X6, were available; and
 - (ii) Made inquiries of certain officials of the company who have responsibility for financial and accounting matters regarding whether the unaudited financial statements referred to in b(i) are stated on a basis substantially consistent with that of the audited financial statements included in the registration statement.

The foregoing procedures do not constitute an examination made in accordance with generally accepted auditing standards. Also, they would not necessarily reveal matters of significance with respect to the comments in the

following paragraph. Accordingly, we make no representations regarding the sufficiency of the foregoing procedures for your purposes.

5. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that—

- a. (i) The unaudited consolidated condensed financial statements described in 4a(i), included in the registration statement, do not comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations and (ii) the unaudited consolidated condensed financial statements are not in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements; or
- b. (i) At May 31, 19X6, there was any change in the capital stock or long-term debt of the company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown in the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement or (ii) for the period from April 1, 19X6, to May 31, 19X6 there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur.

6. As mentioned in 4b, company officials have advised us that no consolidated financial statements as of any date or for any period subsequent to May 31, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after May 31, 19X6, have, of necessity, been even more limited than those with respect to the periods referred to in 4. We have made inquiries of certain company officials who have responsibility for financial and accounting matters regarding whether (a) there was any change at June 25, 19X6, in the capital stock or long-term debt of the company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown on the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement or (b) for the period from April 1, 19X6, to June 25, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change or decrease, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur.

7. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or

sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

Example B: Alternate Wording of the Letter for Companies That Are Permitted to Present Interim Earnings Data for a Twelve-Month Period

.50 Certain types of companies are permitted to include earnings data for a twelve-month period to the date of the latest balance sheet furnished in lieu of earnings data for both the interim period between the end of the latest fiscal year and the date of the latest balance sheet and the corresponding period of the preceding fiscal year. The following would be substituted for the applicable part of numbered paragraph 3 of example A.

3. . . . was to enable us to express our opinion on the financial statements as of December 31, 19X5, and for the year then ended, but not on the financial statements for any period included in part within that year. Therefore, we are unable to and do not express any opinion on the unaudited consolidated condensed balance sheet as of March 31, 19X6, and the related unaudited consolidated condensed statements of income, retained earnings, and changes in financial position for the twelve months then ended included in the registration statement. . . .

Example C: Letter Reaffirming Comments in Example A as of a Later Date

.51 If more than one comfort letter is requested, the later letter may, in appropriate situations, refer to information appearing in the earlier letter without repeating such information (see paragraphs .10 and .48). Example C reaffirms and updates the information in example A.

July 25, 19X6

[Addressee]

Dear Sirs:

We refer to our letter of June 30, 19X6, relating to the registration statement (no. 2-00000) of The Blank Company, Inc. (the company). We reaffirm as of the date hereof (and as though made on the date hereof) all statements made in that letter, except that, for the purposes of this letter—

- a. The registration statement to which this letter relates is as amended as of July 13, 19X6 [effective date].
- b. The reading of minutes described in paragraph 4 of that letter has been carried out through July 20, 19X6 [the new cutoff date].
- c. The procedures and inquiries covered in paragraph 4 of that letter were carried out to July 20, 19X6 [the new cutoff date] (our work

did not extend to the period from July 21, 19X6, to July 25, 19X6 [date of letter], inclusive).

- d. The period covered in paragraph 4b of that letter is changed to the period from April 1, 19X6, to June 30, 19X6; officials of the company have advised us that the latest available financial statements are for the month of June 19X6.
- e. The references to May 31, 19X6, in paragraph 5b of that letter are changed to June 30, 19X6.
- f. The references to May 31, 19X6, and June 25, 19X6, in paragraph 6 of that letter are changed to June 30, 19X6, and July 20, 19X6, respectively.
- g. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

Example D: Alternate Wording When the SEC Has Agreed to a Departure From Its Published Accounting Requirements

.52 Example D is applicable when (a) there is a departure from the applicable accounting requirements of the Act and the related published rules and regulations and (b) representatives of the SEC have agreed to the departure. Numbered paragraph 2 of example A would be revised to read as follows:

2. In our opinion [include the phrase "except as disclosed in the registration statement," if applicable], the financial statements and schedules examined by us and included or incorporated by reference in the registration statement comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations; however, as agreed to by representatives of the SEC, separate financial statements and schedules of ABC Company (an unconsolidated subsidiary) as required by Rule 3-09 of Regulation S-X have been omitted.

Example E: Alternate Wording When Recent Earnings Data Are Presented in Capsule Form

.53 Example E is applicable when (a) the statement of income in the registration statement is supplemented by later information regarding sales and earnings (capsule information) and (b) the accountants are asked to

comment on that information (paragraph .22). The same facts exist as in example A, except for the following:

- a. Sales, net income (no extraordinary items), and earnings per share for the six-month periods ended June 30, 19X6 and 19X5 (both unaudited), are included in capsule form more limited than that specified by APB Opinion No. 28 [AC section I73].
- b. No financial statements later than those for June 19X6 are available.
- c. The letter is dated July 25, 19X6, and the cutoff date is July 20, 19X6.

Numbered paragraphs 4, 5, and 6 of example A should be revised to read as follows:

4. For purposes of this letter we have read the 19X6 minutes ... and have carried out other procedures to July 20, 19X6 (our work did not extend to the period from July 21, 19X6, to July 25, 19X6, inclusive) with respect to the six-month periods ended June 30, 19X6, and 19X5, as follows:

- a. Read the unaudited consolidated condensed balance sheet as of March 31, 19X6, and the unaudited consolidated condensed statements of income, retained earnings, and changes in financial position for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement.
- b. Read the unaudited amounts for sales, net income, and earnings per share for the six-month periods ended June 30, 19X6 and 19X5, as set forth in the paragraph [identify location] and read the unaudited consolidated financial statements furnished us by the company for those periods, from which those amounts were derived.
- c. Made inquiries of certain officials of the company who have responsibility for financial and accounting matters regarding (i) whether the unaudited consolidated condensed financial statements referred to in *a* comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations, (ii) whether those unaudited consolidated condensed financial statements are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements included in the registration statement, and (iii) whether the unaudited amounts referred to in *b* are stated on a basis substantially consistent with that of the corresponding amounts in the audited consolidated statements of income.

The foregoing procedures do not constitute an examination made in accordance with generally accepted auditing standards. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations regarding the sufficiency of the foregoing procedures for your purposes.

5. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that—

- a. (i) The unaudited consolidated condensed financial statements described in 4a, included in the registration statement, do not comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules

and regulations or (ii) those unaudited consolidated condensed financial statements are not in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements;

- b. The unaudited sales and net income amounts, referred to in 4b, (i) do not agree with the amounts set forth in the unaudited consolidated financial statements for those same periods or (ii) were not determined on a basis substantially consistent with that of the corresponding amounts in the audited consolidated statements of income; or
- c. At June 30, 19X6, there was any change in the capital stock or long-term debt of the company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown in the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement, except for changes or decreases that the registration statement discloses have occurred or may occur.

6. Company officials have advised us that no consolidated financial statements as of any date or for any period subsequent to June 30, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after June 30, 19X6, have, of necessity, been even more limited than those with respect to the periods referred to in 4. We have made inquiries of certain company officials who have responsibility for financial and accounting matters regarding whether (a) at July 20, 19X6, there was any change in the capital stock or long-term debt of the company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown on the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement; or (b) for the period from July 1, 19X6, to July 20, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change or decrease, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur.

Example F: Alternate Wording When Accountants Are Aware of a Decrease in a Specified Financial Statement Item

.54 Example F covers a situation in which the accountants are aware of a decrease in a financial statement item on which they are requested to comment (paragraphs .25 through .30). The same facts exist as in example A, except for the decrease covered in the following change in numbered paragraph 5b.

- b. (i) At May 31, 19X6, there was any change in the capital stock or long-term debt of the company and subsidiaries consolidated or any decrease in consolidated net assets as compared with amounts shown

in the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement or (ii) for the period from April 1, 19X6, to May 31, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or the total or per-share amounts of income before extraordinary items or net income, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur except that the unaudited consolidated balance sheet as of May 31, 19X6, which we were furnished by the company, showed a decrease from March 31, 19X6, in consolidated net current assets as follows (in thousands of dollars):

	<u>Current Assets</u>	<u>Current Liabilities</u>	<u>Net Current Assets</u>
March 31, 19X6	\$4,251	\$1,356	\$2,895
May 31, 19X6	3,986	1,732	2,254

6. As mentioned in 4b, company officials have advised us that no consolidated financial statements as of any date or for any period subsequent to May 31, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after May 31, 19X6, have, of necessity, been even more limited than those with respect to the periods referred to in 4. We have made inquiries of certain company officials who have responsibility for financial and accounting matters regarding whether (a) there was any change at June 25, 19X6, in the capital stock or long-term debt of the company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown on the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement; or (b) for the period from April 1, 19X6, to June 25, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change or decrease, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur and except as described in the following sentence. We have been informed by officials of the company that there continues to be a decrease in net current assets that is estimated to be approximately the same amount as set forth in 5b [or whatever other disclosure fits the circumstances].

Example G: Alternate Wording When Accountants' Opinion Contains a Qualification

.55 Example G is applicable when the accountants' opinion on the audited financial statements included in the registration statement contains a qualification regarding a matter that may also affect the unaudited consolidated condensed interim financial statements included in the registration statement. The introductory paragraph in example A would be

revised as indicated in paragraph .34. The following would be substituted for numbered paragraph 5a in example A.

- a. Subject to the effects of adjustments, if any, that might have been required had the outcome of the uncertainty discussed in Note 3 to the consolidated financial statements (which resulted in the qualification of our opinion, as referred to in the introductory paragraph of this letter) been known, (i) the unaudited consolidated condensed financial statements described in 4a(i)

The possible effect of the qualification should also be evaluated to determine whether it also requires mention in the comments on subsequent changes (numbered paragraph 5b of example A). This might occur if the relative possible effect on net income of the matter to which the qualification relates is increasing.

Example H: Alternate Wording When More Than One Accountant Is Involved

.56 Example H applies when more than one accountant is involved in the examination of the financial statements of a business and the principal accountants have obtained a copy of the comfort letter of the other accountants (paragraph .37). Example H consists of an addition of a subparagraph *c* to numbered paragraph 4, a substitution for the applicable part of numbered paragraph 5, and an addition to numbered paragraph 6 of example A.

[4] *c*. We have read the letter dated _____ of [the other accountants] with regard to [the related company].

5. Nothing came to our attention as a result of the foregoing procedures (which, so far as [the related company] is concerned, consisted solely of reading the letter referred to in 4c), however, that caused us to believe that . . .

6. . . . On the basis of these inquiries and our reading of the minutes and the letter dated _____ of [the other accountants] with regard to [the related company], as described in 4, nothing came to our attention that caused us to believe that there was any such change or decrease, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur.

Example I: Comments on Tables, Statistics, and Other Financial Information

.57 Example I is applicable when the accountants are asked to comment on tables, statistics, or other compilations of information appearing in a registration statement (paragraphs .40 through .45). Each of the comments is in response to a specific request. The paragraphs in example I are intended to follow numbered paragraph 6 in example A.

7. For purposes of this letter, we have also read the following, set forth in the registration statement on the indicated pages.²²

<u>Item</u>	<u>Page</u>	<u>Description</u>
<i>a</i>	4	"Capitalization." The amounts under the captions "Amount Outstanding as of June 15, 19X6" and "As Adjusted." The related notes, except the following in Note 2: "See 'Transactions With Interested Persons.' From the proceeds of this offering the company intends to prepay \$900,000 on these notes, pro rata. See 'Use of Proceeds.'"
<i>b</i>	13	"History and Business—Sales and Marketing." The table following the first paragraph.
<i>c</i>	22	"Executive Compensation—19X5 Compensation." The dollar amounts shown in the table "Cash Compensation" and under the headings "Compensation Pursuant to Plans," "Stock Options," and "Other Compensation."
<i>d</i>	33	"Selected Financial Data." ²³ The amounts of net sales, income from continuing operations, income from continuing operations per common share, total assets, long-term obligations, redeemable preferred stock, and cash dividends declared per common share for each of the five years in the period ended December 31, 19X5.

8. Our examination of the consolidated financial statements for the periods referred to in the introductory paragraph of this letter comprised audit tests and procedures deemed necessary for the purpose of expressing an opinion on such financial statements taken as a whole. For none of the periods referred to therein nor any other period did we perform audit tests for the purpose of expressing an opinion on individual balances of accounts or summaries of selected transactions such as those enumerated above, and, accordingly, we express no opinion thereon.

9. However, for purposes of this letter we have performed the following additional procedures, which were applied as indicated with respect to the items enumerated above.

Item

in 7

Procedures and Findings

- a.* We compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6" with the balances in the appropriate accounts in the company's general ledger at May 31, 19X6 (the latest date for which postings had been made), and found them to be in agreement. We were informed by

²² In some cases it may be considered desirable to combine in one paragraph the substance of paragraphs 7 and 9. This may be done by expanding the identification of items in paragraph 9 to provide the identification information contained in paragraph 7. In such cases, the introductory sentences in paragraphs 7 and 9 and the text of paragraph 8 might be combined as follows:

For purposes of this letter, we have also read the following information and have performed the additional procedures stated below with respect to such information. Our examination of the consolidated financial statements . . .

²³ In some cases the company or the underwriters may request that the independent accountants report on "selected financial data" as described in section 552. When the accountants report on this data and the report is included in the registration statement, separate comments should not be included in the comfort letter (see paragraph .18).

*Item*in 7Procedures and Findings

company officials responsible for financial and accounting matters that there had been no changes in such amounts and numbers of shares between May 31, 19X6, and June 15, 19X6. We compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6" adjusted for the issuance of the debentures to be offered by means of the registration statement and for the proposed use of a portion of the proceeds thereof to prepay portions of certain notes, as described under "Use of Proceeds," with the amounts and numbers of shares shown under the caption "As Adjusted" and found such amounts and numbers of shares to be in agreement. (However, we make no comments regarding the reasonableness of the "Use of Proceeds" or whether such use will actually take place.) We compared the description of the securities and the information (except certain information in Note 2, referred to in 7) included in the notes to the table with the corresponding descriptions and information in the company's consolidated financial statements, including the notes thereto included in the registration statement, and found such descriptions and information to be in agreement.

- b. We compared the amounts of military sales, commercial sales, and total sales shown in the registration statement with the balances in the appropriate accounts in the company's general ledger for the respective fiscal years and for the unaudited interim periods and found them to be in agreement. (However, we make no comments regarding the appropriateness of such classification or the manner in which such classification has been made.) We computed the approximate percentages of such amounts of military sales and commercial sales to total sales for the respective fiscal years and for the unaudited interim periods. We compared the computed percentages with the corresponding percentages appearing in the registration statement and found them to be in agreement.
- c. We compared the dollar amounts of cash compensation for each listed individual with the corresponding amounts shown by the individual employee earnings records for the year 19X5 and found them to be in agreement. We compared the dollar amount of aggregate executive officers' cash compensation with the corresponding amount shown in an analysis prepared by the company and found the amounts to be in agreement.

We compared the dollar amounts of compensation pursuant to plans, stock options, and other compensation for each listed individual and the aggregate amounts for executive officers with corresponding amounts shown in an analysis prepared by the company and found such amounts to be in agreement. However, we make no comment regarding the completeness or appropriateness of the company's determination of what constitutes executive compensation for purposes of the SEC disclosure requirements on executive compensation.

- d. We compared the amounts of net sales, income from continuing operations, income from continuing operations per common share, and cash dividends declared per common share for the years ended December 31, 19X5, 19X4, and 19X3, to the consolidated financial

*Item**in 7**Procedures and Findings*

statements on pages 27 and 28 and the amounts for the years ended December 31, 19X2 and 19X1, to the consolidated financial statements included in the company's annual reports to stockholders for 19X2 and 19X1 and found them to be in agreement.

We compared the amounts of total assets, long-term obligations, and redeemable preferred stock at December 31, 19X5 and 19X4, with the consolidated financial statements on pages 27 and 28 and the amounts at December 31, 19X3, 19X2, and 19X1, to the corresponding amounts in the consolidated financial statements included in the company's annual reports to stockholders for 19X3, 19X2, and 19X1, and found them to be in agreement.

10. It should be understood that we make no representations regarding questions of legal interpretation or regarding the sufficiency for your purposes of the procedures enumerated in the preceding paragraph; also, such procedures would not necessarily reveal any material misstatement of the amounts or percentages listed above. Further, we have addressed ourselves solely to the foregoing data as set forth in the registration statement and make no representations regarding the adequacy of disclosure or regarding whether any material facts have been omitted.

11. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

Example J: Summarized Description of Procedures and Findings Regarding Tables, Statistics, and Other Financial Information

.58 Example J illustrates in paragraph 9a a method of summarizing the descriptions of procedures and findings regarding tables, statistics, and other financial information in order to avoid repetition in the comfort letter. The summarization of the descriptions is permitted by paragraph .43. Each of the comments is in response to a specific request. The paragraphs in example J are intended to follow numbered paragraph 6 in example A.²⁴

²⁴ Other methods of summarizing the descriptions may also be appropriately used. For example, the letter may present a matrix listing the financial information and common procedures employed and indicating the procedures applied to specific items.

7. For purposes of this letter, we have also read the following, set forth in the registration statement on the indicated pages.

<u>Item</u>	<u>Page</u>	<u>Description</u>
<i>a</i>	4	"Capitalization." The amounts under the captions "Amount Outstanding as of June 15, 19X6" and "As Adjusted." The related notes, except the following in Note 2: "See 'Transactions With Interested Persons.' From the proceeds of this offering the company intends to prepay \$900,000 on these notes, pro rata. See 'Use of Proceeds.'"
<i>b</i>	13	"History and Business—Sales and Marketing." The table following the first paragraph.
<i>c</i>	22	"Executive Compensation—19X5 Compensation." The dollar amounts shown in the table "Cash Compensation" and under the headings "Compensation Pursuant to Plans," "Stock Options," and "Other Compensation."
<i>d</i>	33	"Selected Financial Data." ²⁵ The amounts of net sales, income from continuing operations, income from continuing operations per common share, total assets, long-term obligations, redeemable preferred stock, and cash dividends declared per common share for each of the five years in the period ended December 31, 19X5.

8. Our examination of the consolidated financial statements for the periods referred to in the introductory paragraph of this letter comprised audit tests and procedures deemed necessary for the purpose of expressing an opinion on such financial statements taken as a whole. For none of the periods referred to therein nor any other period did we perform audit tests for the purpose of expressing an opinion on individual balances of accounts or summaries of selected transactions such as those enumerated above, and, accordingly, we express no opinion thereon.

9. However, for purposes of this letter and with respect to the items enumerated in 7 above—

- a. Except for item 7a, we have (i) compared the dollar amounts either to the amounts in the audited consolidated financial statements described in the introductory paragraph of this letter or, for prior years, included in the company's annual report to stockholders for the years 19X1, 19X2, and 19X3 or to amounts in the unaudited consolidated financial statements described in paragraph 3 to the extent such amounts are included in or can be derived from such statements and found them to be in agreement; (ii) compared the amounts of military sales, commercial sales, and total sales and the dollar amounts of cash compensation for each listed individual to amounts in the company's accounting records and found them to be in agreement; (iii) compared other dollar amounts to amounts in analyses prepared by the company and found them to be in agreement; and (iv) proved the arithmetic accuracy of the percentages based on the data in the above-mentioned financial statements, accounting records, and analyses. With respect to item 7b, we make no comments regarding the appropriateness of the classification of military and commercial sales or the manner in which such classification has been made. With respect to item 7c, we

²⁵ See footnote 23.

make no comment regarding the completeness or appropriateness of the company's determination of what constitutes executive compensation for purposes of the SEC disclosure requirements on executive compensation.

- b. With respect to item 7a, we compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6" with the balances in the appropriate accounts in the company's general ledger at May 31, 19X6 (the latest date for which postings had been made), and found them to be in agreement. We were informed by company officials responsible for financial and accounting matters that there had been no changes in such amounts and numbers of shares between May 31, 19X6, and June 15, 19X6. We compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6" adjusted for the issuance of the debentures to be offered by means of the registration statement and for the proposed use of a portion of the proceeds thereof to prepay portions of certain notes, as described under "Use of Proceeds," with the amounts and numbers of shares shown under the caption "As Adjusted" and found such amounts and numbers of shares to be in agreement. (However, we make no comments regarding the reasonableness of "Use of Proceeds" or whether such use will actually take place.) We compared the description of the securities and the information (except certain information in Note 2, referred to in 7) included in the notes to the table with the corresponding descriptions and information in the company's consolidated financial statements, including the notes thereto, included in the registration statement and found such descriptions and information to be in agreement.

10. It should be understood that we make no representations regarding questions of legal interpretation or regarding the sufficiency for your purposes of the procedures enumerated in the preceding paragraph; also, such procedures would not necessarily reveal any material misstatement of the amounts or percentages listed above. Further, we have addressed ourselves solely to the foregoing data as set forth in the registration statement and make no representations regarding the adequacy of disclosure or regarding whether any material facts have been omitted.

11. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

Example K: Letter When a Short-Form Registration Statement Is Filed Incorporating Previously Filed Forms 10-K and 10-Q by Reference

.59 Example K is applicable when a registrant uses a short-form registration statement (Form S-2 or S-3), which, by reference, incorporates previously filed Forms 10-K and 10-Q. It assumes that the short-form registration statement and prospectus include the Form 10-K for the year ended December 31, 19X5, and Form 10-Q for the quarter ended March 31, 19X6, which have been incorporated by reference. In addition to the information presented below, the letter would also contain paragraphs 6 and 7 of the typical letter in example A.

June 30, 19X6

[Addressee]

Dear Sirs:

We have examined the consolidated balance sheets of The Blank Company, Inc. (the company) and subsidiaries as of December 31, 19X5 and 19X4, and the consolidated statements of income, retained earnings, and changes in financial position for each of the three years in the period ended December 31, 19X5, and the related schedules, all included [or incorporated by reference] in the company's annual report on Form 10-K for the year ended December 31, 19X5, and incorporated by reference in the registration statement (no. 2-00000) on Form S-3 filed by the company under the Securities Act of 1933 (the Act); our report with respect thereto is also incorporated by reference in that registration statement. The registration statement, as amended on May 31, 19X6, is herein referred to as the registration statement.

In connection with the registration statement—

1. We are independent certified public accountants with respect to the company within the meaning of the Act and the applicable published rules and regulations thereunder.

2. In our opinion, the consolidated financial statements and schedules examined by us and incorporated by reference in the registration statement comply in form in all material respects with the applicable accounting requirements of the Act and the Securities Exchange Act of 1934 and the related published rules and regulations.

3. We have not examined any financial statements of the company as of any date or for any period subsequent to December 31, 19X5; although we have made an examination for the year ended December 31, 19X5, the purpose (and therefore the scope) of the examination was to enable us to express our opinion on the consolidated financial statements as of December 31, 19X5, and for the year then ended but not on the consolidated financial statements for any interim period within that year. Therefore, we are unable to and do not express any opinion on the unaudited consolidated condensed

balance sheet as of March 31, 19X6, and the unaudited consolidated condensed statements of income, retained earnings, and changes in financial position for the three-month periods ended March 31, 19X6 and 19X5, included in the company's quarterly report on Form 10-Q for the quarter ended March 31, 19X6, incorporated by reference in the registration statement, or on the financial position, results of operations, or changes in financial position as of any date or for any period subsequent to December 31, 19X5.

4. For purposes of this letter, we have read the 19X6 minutes of the meetings of the stockholders, board of directors, and [include other appropriate committees, if any] of the company and its subsidiaries as set forth in the minute books at June 25, 19X6, officials of the company having advised us that the minutes of all such meetings through that date were set forth therein, and have carried out other procedures to June 25, 19X6 (our work did not extend to the period from June 26, 19X6, to June 30, 19X6, inclusive), as follows:

- a. With respect to the three-month periods ended March 31, 19X6 and 19X5, we have—
 - (i) Read the unaudited consolidated condensed financial statements for these periods, described in 3, included in the company's quarterly report on Form 10-Q for the quarter ended March 31, 19X6, incorporated by reference in the registration statement.
 - (ii) Made inquiries of certain officials of the company who have responsibility for financial and accounting matters regarding (1) whether the unaudited consolidated condensed financial statements referred to in a(i) comply in form in all material respects with the applicable accounting requirements of the Securities Exchange Act of 1934 as it applies to Form 10-Q and the related published rules and regulations and (2) whether those unaudited consolidated condensed financial statements are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements incorporated by reference in the registration statement.
- b. With respect to the period from April 1, 19X6, to May 31, 19X6, we have—
 - (i) Read the unaudited consolidated financial statements of the company and subsidiaries for April and May of both 19X5 and 19X6 furnished us by the company, officials of the company having advised us that no such financial statements as of any date or for any period subsequent to May 31, 19X6, were available; and
 - (ii) Made inquiries of certain officials of the company who have responsibility for financial and accounting matters regarding whether the unaudited consolidated financial statements referred to in b(i) are stated on a basis substantially consistent with that of the audited consolidated financial statements incorporated by reference in the registration statement.

The foregoing procedures do not constitute an examination made in accordance with generally accepted auditing standards. In addition, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations about the sufficiency of the foregoing procedures for your purposes.

5. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that—

- a. (i) The unaudited consolidated condensed financial statements described in 3, incorporated by reference in the registration statement, do not comply in form in all material respects with the applicable accounting requirements of the Securities Exchange Act of 1934 as it applies to Form 10-Q and the related published rules and regulations; or (ii) the unaudited consolidated condensed financial statements are not in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements incorporated by reference in the registration statement; or
- b. (i) At May 31, 19X6, there was any change in the capital stock or long-term debt of the company and consolidated subsidiaries or any decreases in consolidated net current assets or net assets as compared with amounts shown in the March 31, 19X6, unaudited consolidated condensed balance sheet incorporated by reference in the registration statement; or (ii) for the period from April 1, 19X6, to May 31, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income, except in all instances of changes or decreases that the registration statement discloses have occurred or may occur.

Example L: Comments on Pro Forma Financial Information

.60 Example L is applicable when the accountants are asked to comment on (a) compliance as to form of pro forma financial information in a registration statement with applicable accounting requirements of published rules and regulations of the SEC and (b) the application of pro forma adjustments to historical amounts in the compilation of the pro forma financial information (see paragraph .19g). The material in this example is intended to be inserted between numbered paragraphs 6 and 7 in example A. The example assumes that the accountants have not previously reported on the pro forma financial information. If the accountants did previously report on the pro forma financial information, they may refer in the introductory paragraphs of the comfort letter to the fact that they have issued a report, and the report may be attached to the comfort letter (see paragraph .18). In that circumstance, therefore, the procedures in 7b(i) and 7c ordinarily would not be performed, and the accountants should not separately comment on the application of pro forma adjustments in the compilation of the pro forma financial information since that assurance is encompassed in the accountants' report on pro forma financial information attached to the comfort letter. The

accountants may, however, agree to comment on compliance as to form with applicable accounting requirements of published rules and regulations of the SEC.

7. We are unable to and do not express any opinion on such unaudited pro forma consolidated condensed financial statements referred to in 7a or on the pro forma adjustments applied to the historical amounts included in those statements. However, for purposes of this letter and at your request, we have—

- a. Read the unaudited pro forma consolidated condensed balance sheet as of March 31, 19X6, and the unaudited pro forma consolidated condensed statements of income for the year ended December 31, 19X5, and the three-month period ended March 31, 19X6, included [incorporated by reference] in the registration statement.
- b. Made inquiries of certain officials of the company and of XYZ Company (the company being acquired) who have responsibility for financial and accounting matters about—
 - (i) The basis for their determination of the pro forma adjustments, and
 - (ii) Whether the unaudited pro forma consolidated condensed financial statements referred to in 7a comply in form in all material respects with the applicable accounting requirements of Rule 11-02 of Regulation S-X.
- c. Proved the arithmetic accuracy of the application of the pro forma adjustments to the historical amounts in the unaudited pro forma consolidated condensed financial statements.

The foregoing procedures would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representation about the sufficiency of such procedures for your purposes.

8. Nothing came to our attention as a result of the procedures specified in paragraph 7, however, that caused us to believe that the unaudited pro forma consolidated condensed financial statements referred to in 7a included [incorporated by reference] in the registration statement do not comply in form in all material respects with the applicable accounting requirements of Rule 11-02 of Regulation S-X and that the pro forma adjustments have not been properly applied to the historical amounts in the compilation of those statements.

Effective Date

.61 This section is effective for letters for underwriters dated on or after October 31, 1984. Earlier application is encouraged.

→ *The next page is 1201.* ←

AU Section 642

Reporting on Internal Accounting Control

(Supersedes sections 640, "Reports on Internal Control," and 641, "Reports on Internal Control Based on Criteria Established by Governmental Agencies.")

Source: SAS No. 30.

See section 9642 for interpretations of this section.

Issue date, unless otherwise indicated: July, 1980.

.01 This section describes the procedures an independent accountant should apply in connection with various types of engagements to report on an entity's system of internal accounting control, and it describes the different forms of the accountant's report to be issued in connection with such engagements.¹

.02 An independent accountant may be engaged to report on an entity's system of internal accounting control in several ways. The accountant may be engaged to

- a. Express an opinion on the entity's system of internal accounting control in effect as of a specified date (paragraphs .03 through .46). (An accountant may also be engaged to express an opinion on the entity's system of internal accounting control in effect during a specified period of time; in which case, the guidance in such paragraphs should be adapted as appropriate.)
- b. Report on the entity's system, for the restricted use of management, specified regulatory agencies, or other specified third parties, based solely on a study and evaluation of internal accounting control made as part of an audit of the entity's financial statements that is not sufficient for expressing an opinion on the system (paragraphs .47 through .53 in Appendix G).²

¹ The auditor's study and evaluation of internal accounting control in an examination of an entity's financial statements is discussed in section 320 (see Appendix G). The guidance in this section is generally applicable also to engagements to report on internal accounting control. This section provides (1) additional guidance concerning matters that are unique to engagements to report on internal accounting control and (2) a further discussion of certain related matters in section 320 (see Appendix G).

This section amends section 320.77 and sections 323.01, 323.08, and 323.09. See the Appendix at paragraph .62 for the revised wording. (see Appendix G.) [Reference number 320.72, formerly 320.68, changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference number 320.77, formerly 320.72, changed by the issuance of Statement on Auditing Standards No. 48.]

² As the terms are used in this section, *management* includes directors, officers, and others who perform managerial functions, and *regulatory agencies* include governmental and other agencies, such as stock exchanges, that exercise regulatory, supervisory, or other public administrative functions.

- c. Report on all or part of entity's system, for the restricted use of management or specified regulatory agencies, based on the regulatory agencies' pre-established criteria (paragraphs .54 through .59).
- d. Issue other special-purpose reports on all or part of an entity's system for the restricted use of management, specified regulatory agencies, or other specified third parties (paragraphs .60 and .61).

An accountant may also be involved with an entity's system of internal accounting control in ways that do not involve reporting in accordance with this section. For example, an accountant may be engaged to consult on improving the system. In these circumstances the accountant may communicate the results of his engagement by letters, memoranda, and other less formal means solely for the internal information of management.*

Expression of an Opinion on an Entity's System of Internal Accounting Control

.03 This section [paragraphs .03—.46] describes the general considerations, the study and evaluation, and the form of the accountant's report applicable to an engagement to express an opinion on an entity's system of internal accounting control. The accountant does not need to place any restrictions on the use of this report.

General Considerations

The Objectives of Internal Accounting Control

.04 The broad objectives of internal accounting control, as defined in section 320.27 (see Appendix G), are to provide management with reasonable, but not absolute, assurance that assets are safeguarded from unauthorized use or disposition and that financial records are reliable to permit the preparation of financial statements. The definition also sets forth the following operative objectives that are necessary to achieve the broad objectives:

- a. Transactions are executed in accordance with management's general or specific authorization.
- b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- c. Access to assets is permitted only in accordance with management's authorization.
- d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

[Reference changed by the issuance of Statement on Auditing Standards No. 48.]

.05 In the context of internal accounting controls, *safeguarding of assets* refers only to protection against loss arising from errors and irregularities in

* For additional guidance on reporting to another independent accountant on internal accounting control, see section 324, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*.

processing transactions and handling the related assets.³ It does not include the loss of assets arising from management's operating business decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that later prove to be unnecessary or unsatisfactory, authorizing what turns out to be unproductive research or ineffective advertising, or accepting some level of customer pilferage of merchandise as part of operating a retail business.

.06 The objective concerning the reliability of financial records relates to financial statements regularly released to users outside the entity. This would include annual financial statements, interim financial statements, and summarized financial data derived from such statements.

.07 The preparation of financial statements requires the use of estimates and judgments, and internal accounting control includes controls relating to those estimates and judgments. The nature of such controls, however, differs from that of controls relating to the execution and recording of transactions and to the safeguarding of assets. Estimates and judgments are necessarily subjective and relate largely to future conditions and events; accordingly, internal accounting controls relating to estimates and judgments are limited to those procedures designed to provide reasonable assurance that individuals at appropriate levels in the organization review and consider sufficient, reliable information in making the required estimates and judgments.

Limitations

.08 There are inherent limitations, discussed in section 320.35 (see Appendix G), that should be recognized in considering the potential effectiveness of any system of internal accounting control. Particularly significant for the purpose of reports on internal accounting control is "any projection of a current evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with prescribed procedures may deteriorate." [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

Relationship to the Study and Evaluation Made in an Audit

.09 An engagement to express an opinion on an entity's system of internal accounting control and a study and evaluation of internal accounting controls made as part of an examination of financial statements in accordance with generally accepted auditing standards differ in purpose and generally differ in scope. While the former can be made in conjunction with the latter, an engagement to express an opinion on the system of internal accounting control can be made as of a different date or by a different accountant as long as the accountant obtains the necessary understanding of the entity's operations (see paragraph .14).

.10 The purpose of an engagement to express an opinion on an entity's system of internal accounting control differs from the purpose of the study and evaluation of internal accounting controls made as part of an audit. The auditor's study and evaluation of internal accounting control is an intermediate step in forming an opinion on the financial statements. It establishes a basis for determining the extent to which auditing procedures are to be restricted and assists the auditor in planning and performing his examination.

³ A note to section 320.37 (see Appendix G) specifies that "errors" refers to unintentional mistakes, and "irregularities" refers to intentional distortions of financial statements and to defalcations." [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

In an audit, the auditor may decide not to rely on prescribed control procedures because he concludes either (a) that the procedures are not satisfactory for his purposes or (b) that the audit effort required to test compliance with the procedures to justify reliance on them would exceed the reduction in effort that could be achieved by such reliance. Accordingly, the study and evaluation of the system of internal accounting control in an audit is generally more limited than that made in connection with an engagement to express an opinion on the system of internal accounting control. Nevertheless, an accountant's opinion on a system of internal accounting control does not increase the reliability of financial statements that have been audited.

.11 Although the scope of the study and evaluation of internal accounting controls in an engagement to express an opinion on the system of internal accounting control generally differs from that of an audit, the procedures are similar in nature. Thus, the study and evaluation made in connection with an engagement to express an opinion on the system may also serve as a basis for reliance on internal accounting controls in determining the nature, timing, and extent of audit tests. Furthermore, an accountant need not apply procedures in an audit that duplicate procedures that have been applied for the purpose of expressing an opinion on an entity's system of internal accounting control.

Relationship to the Foreign Corrupt Practices Act

.12 The Foreign Corrupt Practices Act of 1977 (FCPA) includes provisions regarding internal accounting control for companies subject to the Securities Exchange Act of 1934. Whether a company is in compliance with those provisions of the FCPA is a legal determination. An independent accountant's opinion does not indicate whether the company is in compliance with those provisions but may be helpful to management in evaluating the company's compliance.

The Study and Evaluation

.13 In making a study and evaluation for the purpose of expressing an opinion on an entity's system of internal accounting control in effect as of a specified date, the accountant should (a) plan the scope of the engagement, (b) review the design of the system, (c) test compliance with prescribed procedures, and (d) evaluate the results of his review and tests.

Planning the Scope of the Engagement

.14 *General considerations.* Among the factors to be considered in planning the scope of the engagement are

- a. The nature of the entity's operations, including the susceptibility of assets to unauthorized use or misappropriation in light of their mobility or salability and the nature and volume of transactions.
- b. The overall control environment, including
 1. The entity's organizational structure, including the duties and authority of the board of directors and its audit committee (or comparable bodies), senior management, and management of subsidiaries, affiliates, divisions, or other operating units.
 2. The methods used to communicate responsibility and authority.
 3. The principal financial reports prepared for management planning and control purposes, such as budgets.

4. Management's supervision of the system, including the internal audit function, if any.
5. Competence of personnel.
- c. The extent of recent changes, if any, in the entity, its operations, or its control procedures.
- d. Relative significance of the various classes of transactions and related assets.
- e. Knowledge obtained in auditing the entity's financial statements and in past engagements to express an opinion on the entity's system.

.15 Multiple locations. For an entity with operations in several locations, the considerations involved in deciding the locations to study are similar to those involved in an audit. It may not be necessary to review and test the controls at each location. In addition to the factors listed in paragraph .14, the selection of locations to be visited should be based on factors such as (a) the similarity of business operations and control systems at different locations, (b) the degree of centralization of accounting records, (c) the effectiveness of the internal reporting system used by senior management to supervise activities at various locations, (d) the effectiveness of other supervisory activities, such as an internal audit function, and (e) the nature and amount of transactions and related assets at the various locations.

.16 Internal audit. Reviewing and testing the system of internal accounting control is often an important responsibility of the internal audit function. Thus, the work of the internal auditors may have an important bearing on the independent accountant's procedures. If the independent accountant will be considering or using the work of, or receiving direct assistance from, the entity's internal auditors, the accountant should follow the guidance in section 322 in considering their competence and objectivity and in evaluating their work.

.17 Documentation. For the accountant to be able to report on the system of internal accounting control, the accountant and management should have a common understanding both of the specific control objectives appropriate to the circumstances and of the control procedures in effect that are designed to achieve those objectives. The specific control objectives and related procedures should be appropriately documented to serve as a basis for the accountant's report. The documentation of the system may take many forms: internal control manuals, accounting manuals, narrative memoranda, flowcharts, decision tables, procedural writeups, or answers to questionnaires. No one particular form of documentation is necessary, and the extent of documentation will vary.

Reviewing the Design of the System

.18 The purpose of the review of the design of the system is to obtain sufficient information to permit the accountant to reach a conclusion about whether the entity's control procedures are suitably designed to achieve the objectives of internal accounting control.⁴ For this purpose the accountant should obtain an understanding of

- a. The flow of transactions through the accounting system.

⁴ The "design" of the system refers to the plan of organization and the procedures and records that have been established.

- b. The specific control objectives that relate to points in the flow of transactions and handling of assets where errors or irregularities could occur.
- c. The specific control procedures or techniques that the entity has established to achieve the specific control objectives.

.19 *The flow of transactions.* The accounting system should be distinguished from the system of internal accounting control. While an accounting system may include procedures that contribute to achieving a control objective, its primary purpose is to process transactions. An accountant obtains an understanding of the accounting system to identify points in the processing of transactions and handling of assets where errors or irregularities may occur.

.20 The accountant should obtain an understanding of the system for processing each significant class of transactions. The accountant should identify the classes of transactions processed and the related assets and, for each significant class, identify the flow of transactions from authorization through execution and recording of transactions and the accountability for the resulting assets. Transactions may be grouped in a variety of ways—for example, by cycles of business activity or by business functions.⁵ Whatever approach is used, the accountant should identify each significant class of transactions and obtain an understanding of the flow of transactions. The accountant's procedures in obtaining such an understanding may include inspection of written documentation, inquiries of client personnel, and observation of the processing of transactions and the handling of the related assets.

.21 *Specific control objectives.* Paragraph .04 lists the four operative objectives of internal accounting control. Those operative objectives need to be further refined into specific control objectives for the purpose of identifying and evaluating the controls over specific classes of transactions and related assets within an entity. The accountant should determine whether management has identified the specific control objectives relating to points in the processing of transactions and the handling of assets where errors or irregularities could occur. An example of a specific control objective in a revenue cycle is that all goods shipped are billed.

.22 *Specific control procedures.* A system of internal accounting control should include specific control procedures designed to achieve the specific objectives of internal accounting control for each significant class of transactions and related assets. The accountant should consider the effectiveness of the specific control procedures either individually or in combination, taking into consideration the overall control environment and other applicable considerations discussed in paragraph .14. The accountant should focus on procedures in terms of their significance to the achievement of specific objectives rather than consider the specific procedures in isolation. Thus, when one or more specific control procedures are adequate to achieve a specific objective, the accountant need not consider other procedures. Alternatively, the absence or the inadequacy of one specific control procedure designed to achieve a specific objective may not be a weakness if other specific control procedures achieve the same objective.

.23 There are two general levels of control procedures: primary and secondary. Primary control procedures are designed to achieve one or more

⁵ Section 320.22 (see Appendix G) explains, "Execution of transactions includes the entire cycle of steps necessary to complete the exchange of assets between parties or the transfer or use of assets within the business. . . . For example, the typical sale would involve acceptance of an order, shipment and billing of the product, and collection of the billing." [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

specific control objectives, and they generally are applied at points where errors or irregularities could occur in the processing of transactions and the handling of assets. Primary control procedures may be applied to transactions and assets individually or at various levels of summarization. Examples of primary control procedures are monthly reconciliations of bank accounts and systematic matching of receiving documents with vendor invoices, when these functions are performed by persons who have no incompatible duties.

.24 Secondary control procedures include any administrative controls or other management functions that achieve, or contribute to the achievement of, specific control objectives and thus are comprehended in the definition of internal accounting control (section 320.11 in Appendix G). Such procedures are designed primarily to achieve broader management objectives, and they are not a part of the processing of transactions and the handling of assets. Examples of secondary controls include the systematic comparison of recorded transactions and account balances with expected results based on such sources of information as budgets, standard costs, engineering estimates, prior experience, and management's personal knowledge of operations. The effectiveness of such comparisons for the purpose of deterring or detecting errors and irregularities depends on the reliability of the sources of information used and on the thoroughness of the investigation of variations from the expected results. Accordingly, careful consideration and judgment is required in evaluating the effectiveness of secondary controls. [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

Testing Compliance With Prescribed Procedures

.25 The purpose of tests of compliance is to provide a basis for the accountant to reach a conclusion about whether the specific control procedures necessary for the achievement of specific control objectives are being applied as prescribed as of the specified date of his study and evaluation.

.26 The nature and extent of the accountant's tests of compliance with prescribed procedures in an engagement to express an opinion on the system of internal accounting control involve essentially the same considerations as tests of compliance made as part of an audit. The nature, timing, and extent of the auditor's tests of compliance with those controls on which he relies in an audit are discussed in section 320.64—.72 (see Appendix G). [Reference changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

.27 In an engagement to express an opinion on a system as of a specified date, the period of time necessary for testing compliance varies with the nature of the controls being tested. Some control procedures may function continuously (for example, control procedures over sales), but other control procedures may operate only at certain times (for example, control procedures relating to the preparation of interim financial statements). In addition, some control procedures that function continuously may be used frequently (for example, control procedures over customer receivables), while others may be used less frequently (for example, control procedures over advances to employees). The accountant should test compliance with control procedures over a period that is adequate for him to determine whether the specific control procedures are being applied as prescribed as of the date specified in his report.

.28 Management may change its system of internal accounting control to correct weaknesses in the existing system or to make it more efficient. The accountant does not need to consider the superseded controls. If the accountant determines that the new control procedures achieve the related specific objectives of internal accounting control and that the procedures have been in effect for a sufficient time to permit the accountant to test compliance with them, the accountant's review and testing of these procedures would not require any additional considerations.

Evaluating the Results of the Review of the Design of the System and Tests of Compliance

.29 In evaluating a system of internal accounting control for the purpose of expressing an opinion on the system as a whole, the accountant should consider the results of his review of the design of the system and of his tests of compliance. For this purpose, the accountant should identify weaknesses in the system and evaluate whether they are material, either individually or in combination.

.30 A weakness in internal accounting control is a condition in which the specific control procedures, or the degree of compliance with them, are not sufficient to achieve a specific control objective—that is, errors or irregularities may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. A weakness is material if the condition results in more than a relatively low risk of such errors or irregularities in amounts that would be material in relation to financial statements (see paragraph .06).

.31 In evaluating an individual weakness, the accountant should recognize that

- a. The amounts of errors or irregularities that may occur and remain undetected range from zero to the gross amount of assets or transactions exposed to the weakness.
- b. The risk or probability of errors or irregularities is likely to be different for the different possible amounts within that range. For example, the risk of errors or irregularities in amounts equal to the gross exposure may be very low, but the risk of smaller amounts may be progressively greater.

.32 In evaluating the combined effect of individually immaterial weaknesses, the accountant should consider

- a. The range or distribution of the amounts of errors or irregularities that may result during the same accounting period from two or more individual weaknesses.
- b. The joint risk or probability that such a combination of errors or irregularities would be material.

.33 The evaluation of identified weaknesses necessarily is a very subjective process that depends on such factors as the nature of the accounting process and of any assets exposed to the weaknesses, the overall control environment, and the experience and judgment of those making the estimates. The accountant should consider, to the extent that it is applicable in the current conditions, any relevant historical data that are available or can reasonably be developed.

.34 Historical data provide a more reasonable basis for estimating the risk of errors than they do for estimating the risk of irregularities. Errors are unintentional, and their underlying causes tend to result in a more recurring or predictable level of occurrence. Irregularities are intentional, and their underlying causes ordinarily involve a lack of integrity and a motivation for personal gain, which are less predictable from historical experience. Thus, the accountant should presume a high risk of irregularities if inadequate segregation of duties places an individual in a position to perpetrate and to conceal irregularities in the normal course of that person's duties.

Management's Written Representations

.35 The accountant should ordinarily obtain management's written representations

- a. Acknowledging management's responsibility for establishing and maintaining the system of internal accounting control.
- b. Stating that management has disclosed to the accountant all material weaknesses in the system of which they are aware, including those for which management believes the cost of corrective action may exceed the benefits.
- c. Describing any irregularities involving management or employees who have significant roles in the system of internal accounting control.
- d. Stating whether there were any changes subsequent to the date being reported on that would significantly affect the system of internal accounting control, including any corrective action taken by management with regard to material weaknesses.

The Accountant's Working Papers

.36 The extent to which the accountant documents the engagement to express an opinion on a system of internal accounting control is a matter of professional judgment. The judgment is similar to that made in connection with an audit. Documents prepared by the entity to describe its system of internal accounting control may be used by the accountant in his working papers.

The Form of the Accountant's Report

.37 An independent accountant may express an opinion on a system of internal accounting control of any entity for which financial statements in conformity with generally accepted accounting principles, or any other criteria applicable to such statements, can be prepared.

.38 The accountant's report expressing an opinion on an entity's system of internal accounting control should contain

- a. A description of the scope of the engagement.
- b. The date to which the opinion relates.
- c. A statement that the establishment and maintenance of the system is the responsibility of management.
- d. A brief explanation of the broad objectives and inherent limitations of internal accounting control.
- e. The accountant's opinion on whether the system taken as a whole was sufficient to meet the broad objectives of internal accounting

control insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to financial statements.

The report should be dated as of the date of completion of field work and may be addressed to the entity whose system is being studied or to its board of directors or stockholders.

Standard Form of Report

.39 The following language should be used to express an unqualified opinion on an entity's system of internal accounting control:

We have made a study and evaluation of the system of internal accounting control of XYZ Company and subsidiaries in effect at (date). Our study and evaluation was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

The management of XYZ Company is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the degree of compliance with the procedures may deteriorate.

In our opinion, the system of internal accounting control of XYZ Company and subsidiaries in effect at (date), taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the consolidated financial statements.

Reporting Material Weaknesses

.40 If the study and evaluation discloses conditions that, individually or in combination, result in one or more material weaknesses, the opinion paragraph of the accountant's report (paragraph .39) should be modified as follows:

Our study and evaluation disclosed the following conditions in the system of internal accounting control of XYZ Company and subsidiaries in effect at (date), which, in our opinion, result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the consolidated financial statements may occur and not be detected within a timely period.

The report should describe the material weaknesses, state whether they result from the absence of control procedures or the degree of compliance with them, and describe the general nature of potential errors or irregularities that may occur as a result of the weaknesses. The accountant may want to report to management other weaknesses even though they are not considered to be material (see paragraphs .51 through .53).

.41 If a document that contains an accountant's opinion identifying a material weakness also includes a statement by management asserting that

the cost of correcting the weakness would exceed the benefits of reducing the risk of errors or irregularities, the accountant should not express any opinion as to management's statement.⁶ However, the accountant is not precluded from disclaiming an opinion on any such statement.

.42 If management has implemented control procedures to correct the weakness, the accountant should not refer to this corrective action unless he has satisfied himself that the procedures are suitably designed and are being applied as prescribed.

.43 If the opinion on the internal accounting control system is issued in conjunction with an examination of the entity's financial statements, the following sentence should be included in the paragraph that describes the material weakness:

These conditions were considered in determining the nature, timing, and extent of audit tests to be applied in our examination of the 19XX financial statements, and this report does not affect our report on these financial statements dated (date of report).

Scope Limitations

.44 An unqualified opinion on an entity's system of internal accounting control can be expressed only if the accountant has been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of his engagement, whether imposed by the client or by the circumstances, may require the accountant to qualify or disclaim an opinion. The accountant's decision to qualify or disclaim an opinion because of a scope limitation depends on the accountant's assessment of the importance of the omitted procedure(s) to his ability to form an opinion on the system of internal accounting control. When restrictions that significantly limit the scope of the study and evaluation are imposed by the client, the accountant generally should disclaim an opinion on the system of internal accounting control.

Opinion Based in Part on the Report of Another Accountant

.45 When an accountant decides to make reference to the report of another accountant as a basis, in part, for his opinion, he should disclose this fact in stating the scope of his examination and should refer to the report of the other accountant in expressing his opinion. In these circumstances, the considerations are similar to those that arise when the independent auditor reporting on financial statements uses the work and reports of other independent auditors (see section 543).

Subsequent Information

.46 The accountant has no responsibility to keep informed of events subsequent to the date of the report; however, the accountant may later become aware of conditions that existed at the date of the report that might have affected his opinion had he been aware of them. The accountant's consideration of such subsequent information is similar to an auditor's consideration of comparable information discovered subsequent to the date of his report on an audit of financial statements (see section 561).

⁶ This is not intended to preclude an accountant from advising his client with respect to the practicability of specific control procedures that may be under consideration. However, as is the case in other matters involving advice by an accountant, it is the responsibility of management to make the decisions concerning costs to be incurred and related benefits.

Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit [7] [8] [9]

[.47—.53] [Superseded April 1988, by Statement on Auditing Standards No. 60.] (See section 325.)

Reports Based on Criteria Established by Regulatory Agencies

.54 Some governmental or other agencies that exercise regulatory, supervisory, or other public administrative functions may require reports on internal accounting controls of organizations subject to their regulations. A report on internal accounting control in the form illustrated in paragraphs .39 or .49 may be acceptable to such an agency; however, an agency may set forth specific criteria for the evaluation of the adequacy of internal accounting control procedures for their purposes and may require a report based on those criteria.

.55 Criteria established by an agency may be set forth in audit guides, questionnaires, or other publications. The criteria may encompass specified aspects of internal accounting control and may also encompass specified aspects of administrative control or of compliance with grants, regulations, or statutes. For the accountant to be able to issue the report described in paragraph .56, the criteria should be in reasonable detail and in terms susceptible to objective application.¹⁰

.56 The accountant's report should (a) clearly identify the matters covered by his study,¹¹ (b) indicate whether the study included tests of compliance with the procedures covered by his study, (c) describe the objectives and limitations of internal accounting control and of accountants' evaluations of it, (d) state the accountant's conclusions, based on the agency's criteria, concerning the adequacy of the procedures studied, with an exception regarding any material weaknesses, and (e) state that it is intended for use in connection with the grant or other purpose to which the report refers and that it should not be used for any other purpose.¹² If the agency requires the accountant to report on all conditions (whether material or not) that are not in conformity with the agency's criteria, the accountant should do so. If the agency does not require the accountant to report on conditions that are not material, he may do so, and he may also include recommendations for corrective action or describe corrective actions taken by the organization (see paragraph .42).

.57 For the purpose of these reports, a material weakness includes either (a) a condition that results in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the applicable grant or program may occur and not be detected within a timely period by

[7] [Superseded April 1988, by Statement on Auditing Standards No. 60.] (See section 325).

[8] [Superseded April 1988, by Statement on Auditing Standards No. 60.] (See section 325).

[9] [Superseded April 1988, by Statement on Auditing Standards No. 60.] (See section 325).

¹⁰ Also, an agency may require a report on the design of an internal accounting control system before the organization has started operations.

¹¹ This can be accomplished by reference to the publication in which the established criteria are set forth.

¹² This form of reporting is appropriate even though the regulatory agency may make the accountant's report a matter of public record.

employees in the normal course of performing their assigned functions or (b) a condition in which the lack of conformity with the agency's criteria is material in accordance with any guidelines for determining materiality that are included in such criteria.

.58 When the accountant issues this form of report, he does not assume any responsibility for the comprehensiveness of the criteria established by the agency; however, he should report any relevant condition that comes to his attention in the course of his study that he believes to be a material weakness, even though it is not covered by such criteria.

.59 The following report is illustrative of the type of report considered appropriate for a study based on pre-established criteria:

(Scope paragraph)

We understand that (recipient) has been awarded a grant of (amount) from (agency) for the period from (date) through (date) for use in accordance with the (title or description of program). We have made a study of those internal accounting control and administrative control procedures of (recipient) that we considered relevant to the criteria established by (agency), as set forth in (section) of its audit guide, issued (date). Our study included tests of compliance with such procedures during the period from (date) through (date). Our study did not constitute an audit of any financial statements prepared by (recipient).

(Explanatory paragraphs, see paragraph .39) *

(Concluding paragraphs)

We understand that procedures in conformity with the criteria referred to in the first paragraph of this report are considered by the (agency) to be adequate for its purpose in accordance with (name of act) and related regulations, and that procedures not in conformity with those criteria indicate some inadequacy for such purposes. Based on this understanding and on our study, we believe (recipient's) procedures were adequate for the agency's purposes, except for the conditions described (reference to appropriate section of report), which we believe are material weaknesses in relation to the grant to which this report refers. In addition to these weaknesses, other conditions that we believe are not in conformity with the criteria referred to above are described (reference to appropriate section of report).

This report is intended for the information of (recipient) and (agency) and should not be used for any other purpose.

Other Special Purpose Reports

.60 An accountant may be engaged to issue a special report for the restricted use of management, another independent accountant, or other specified third parties, on all or a part of an entity's system of internal accounting control or proposed system of internal accounting control. For example, such reports may relate to (a) a study of system design without tests of compliance or (b) the results of applying agreed-upon procedures that are not sufficient for the purpose of expressing an opinion on the system taken as a whole.[†]

.61 The form of report in these circumstances is flexible, but it should (a) describe the scope and nature of the accountant's procedures, (b) disclaim an opinion on whether the system, taken as a whole, meets the objectives of

* EDITOR'S NOTE: See section 9642.02.

[†] For additional guidance on reporting to another independent accountant on internal accounting control, see section 324, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*.

internal accounting control, (c) state the accountant's findings, and (d) indicate that the report is intended solely for management or specified third parties.**

Appendix

.62 This section amends section 323, *Required Communication of Material Weaknesses in Internal Accounting Control*, paragraphs .01, .08 and .09 (see Appendix G) to read as follows:

1. This section requires the auditor to communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control that come to his attention during an examination of financial statements made in accordance with generally accepted auditing standards.* A material weakness in internal accounting control is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. See section 642.31—.34 for factors to be considered in estimating the amounts of errors and irregularities that might result from identified weaknesses in internal accounting control.

* * * *

8. The form of communication is optional. When the auditor communicates in writing, the suggested form of report is included in section 642.49—.50. Because it is not practicable to communicate the varying extent of such studies in different engagements, these reports should be prepared for the restricted use of management, the board of directors, or its audit committee.**

9. If the auditor becomes aware of material weaknesses for which management believes corrective action is not practicable, he may refer to the circumstances and summarize the weaknesses; a detailed communication of the circumstances and related weaknesses is not required. When a written report is issued, the related sentence would state: "However, our study and evaluation disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements may occur and not be detected within a timely period, but management believes corrective action is not practicable in the circumstances." The auditor would then summarize the weaknesses and describe the circumstances (for example, inadequate control over cash transactions because of inadequate segregation of duties due to limited personnel).

This section amends section 320.77 (see Appendix G) to read as follows:

The auditor's evaluation of accounting control with reference to each significant class of transactions and related assets should be a conclusion about whether the prescribed procedures and compliance therewith are satis-

** See footnotes 7 and 12. [Footnote added by Auditing Standards Board.]

* See also section 722.10, *Review of Interim Financial Information*, which states: "If the system of internal accounting control appears to contain weaknesses that do not permit preparation of interim financial information in conformity with generally accepted accounting principles, and, as a consequence, it is impracticable for the accountant to effectively apply his knowledge of financial reporting practices to the interim financial information, he should consider whether the weaknesses represent a restriction on the scope of his engagement sufficient to preclude completion of such a review. . . . The accountant should also advise senior management and the board of directors or its audit committee of the circumstances. . . ." [Reference changed by issuance of SAS No. 36.]

** However, when the study and evaluation made as a part of the audit is sufficient for expressing an opinion on the system, see section 642.37—.46.

factory for his purpose. The procedures and compliance should be considered satisfactory if the auditor's review and tests disclose no condition he believes to be a material weakness for his purpose. In this context, a material weakness is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. These criteria may be broader than those that may be appropriate for evaluating weaknesses in accounting control for management or other purposes. If the auditor is aware of a material weakness in internal accounting control, whether or not he is specifically engaged by the client to review and report on the system of internal accounting control, a communication as described in section 323, *Required Communication of Material Weaknesses in Internal Accounting Control*, is required.

[Reference number 320.72, formerly 320.68, changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference number 320.77, formerly 320.72, changed by the issuance of Statement on Auditing Standards No. 48.]

AU Section 700

SPECIAL TOPICS

... filings under federal securities statutes ...
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➡ The next page is 1331. ←

AU Section 711

Filings Under Federal Securities Statutes

Source: SAS No. 37.

See section 9711 for interpretations of this section.

Issue date, unless otherwise indicated: April, 1981.

.01 As in the case of financial statements used for other purposes, management has the responsibility for the financial representations contained in documents filed under the federal securities statutes. In this connection the Securities and Exchange Commission has said:

The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon the accounting.¹

.02 When an independent accountant's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes, the accountant's responsibility, generally, is in substance no different from that involved in other types of reporting. However, the nature and extent of this responsibility are specified in some detail in these statutes and in the related rules and regulations. For example, section 11(a) of the Securities Act of 1933, as amended, imposes responsibility for false or misleading statements in an effective registration statement, or for omissions that render statements made in such a document misleading, on

every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him.

.03 Section 11 also makes specific mention of the independent accountant's responsibility as an expert when his report is included in a registration statement filed under that act.² Section 11(b) states, in part, that no person

NOTE: This section supersedes Statement on Auditing Standards No. 1, section 710, *Filings Under Federal Securities Statutes*. The changes provide guidance for the accountant whose report based on a review of interim financial information is presented, or incorporated by reference, in a filing under the Securities Act of 1933.

¹ 4 S. E. C. 721 (1939).

² Under rules of the Securities and Exchange Commission, a report based on a review of interim financial information is not a report by the accountant under section 11 (see paragraph .06).

shall be liable as provided therein if that person sustains the burden of proof that

as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert. . . .

Section 11 further provides that, in determining what constitutes reasonable investigation and reasonable ground to believe, "the standard of reasonableness shall be that required of a prudent man in the management of his own property."

.04 This discussion of the independent accountant's responsibilities in connection with filings under the federal securities statutes is not intended to offer legal interpretations and is based on an understanding of the meaning of the statutes as they relate to accounting principles and auditing standards and procedures. The discussion is subject to any judicial interpretations that may be issued.

.05 Because a registration statement under the Securities Act of 1933 speaks as of its effective date, the independent accountant whose report is included in such a registration statement has a statutory responsibility that is determined in the light of the circumstances on that date. This aspect of responsibility is peculiar to reports used for this purpose (see paragraphs .10 through .12).

.06 Under rules of the Securities and Exchange Commission, an independent accountant's report based on a review of interim financial information is not a report by the accountant within the meaning of section 11. Thus, the accountant does not have a similar statutory responsibility for such reports as of the effective date of the registration statement (see paragraph .13).

.07 The other federal securities statutes, while not containing so detailed an exposition, do impose responsibility, under certain conditions, on persons making false or misleading statements with respect to any material fact in applications, reports, or other documents filed under the statute.

.08 In filings under the Securities Act of 1933, a statement frequently is made in the prospectus (sometimes included in a section of the prospectus

called the *experts section*) that certain information is included in the registration statement in reliance upon the report of certain named experts. The independent accountant should read the relevant section of the prospectus to make sure that his name is not being used in a way that indicates that his responsibility is greater than he intends. The experts section should be so worded that there is no implication that the financial statements have been prepared by the independent accountant or that they are not the direct representations of management.

.09 The Securities and Exchange Commission requires that, when an independent accountant's report based on a review of interim financial information is presented or incorporated by reference in a registration statement, a prospectus that includes a statement about the independent accountant's involvement should clarify that his review report is not a "report" or "part" of the registration statement within the meaning of sections 7 and 11 of the Securities Act of 1933. In this respect, wording such as the following in a prospectus would ordinarily be considered a satisfactory description for the accountant's purposes of the status of his review report that was included in a Form 10-Q filing that was later incorporated by reference in a registration statement.³

Independent Public Accountants

The consolidated balance sheets as of December 31, 19X2 and 19X1, and the consolidated statements of income, retained earnings, and changes in financial position for each of the three years in the period ended December 31, 19X2, incorporated by reference in this prospectus, have been included herein in reliance on the report of _____ independent public accountants, given on the authority of that firm as experts in auditing and accounting.

With respect to the unaudited interim financial information for the periods ended March 31, 19X3 and 19X2, incorporated by reference in this prospectus, the independent public accountants have reported that they have applied limited procedures in accordance with professional standards for a review of such information. However, their separate report included in the company's quarterly report on Form 10-Q for the quarter ended March 31, 19X3, and incorporated by reference herein, states that they did not audit and they do not express an opinion on that interim financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. The accountants are not subject to the liability provisions of section 11 of the Securities Act of 1933 for their report on the unaudited interim financial information because that report is not a "report" or a "part" of the

³ A similar description of the status of the accountant's report would also ordinarily be satisfactory for the accountant's purposes when the accountant's review report is presented in the registration statement rather than incorporated by reference. In that case, the description in the prospectus would specifically refer to that report in the registration statement.

registration statement prepared or certified by the accountants within the meaning of sections 7 and 11 of the act.

The independent accountant should also read other sections of the prospectus to make sure that his name is not being used in a way that indicates that his responsibility is greater than he intends.

Subsequent Events Procedures in 1933 Act Filings

.10 To sustain the burden of proof that he has made a "reasonable investigation" (see paragraph .03), as required under the Securities Act of 1933, an auditor should extend his procedures with respect to subsequent events from the date of his audit report up to the effective date or as close thereto as is reasonable and practicable in the circumstances. In this connection, he should arrange with his client to be kept advised of the progress of the registration proceedings so that his review of subsequent events can be completed by the effective date. The likelihood that the auditor will discover subsequent events necessarily decreases following the completion of field work, and, as a practical matter, after that time the independent auditor may rely, for the most part, on inquiries of responsible officials and employees. In addition to performing the procedures outlined in section 560.12, at or near the effective date, the auditor generally should

- a. Read the entire prospectus and other pertinent portions of the registration statement.
- b. Inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters (limited where appropriate to major locations) about whether any events have occurred, other than those reflected or disclosed in the registration statement, that, in the officers' or other executives' opinion, have a material effect on the audited financial statements included therein or that should be disclosed in order to keep those statements from being misleading.

.11 A registration statement filed with the Securities and Exchange Commission may contain the reports of two or more independent auditors on their examinations of the financial statements for different periods. An auditor who has examined the financial statements for prior periods but has not examined the financial statements for the most recent audited period included in the registration statement has a responsibility relating to events subsequent to the date of the prior-period financial statements, and extending to the effective date, that bear materially on the prior-period financial statements on which he reported. Generally, he should

- a. Read pertinent portions of the prospectus and of the registration statement.
- b. Obtain a letter of representations from the successor independent auditor regarding whether his examination (including his procedures with respect to subsequent events) revealed any matters that, in his opinion, might have a material effect on the financial statements

reported on by the predecessor auditor or would require disclosure in the notes thereto.

The auditor should make inquiries and perform other procedures that he considers necessary to satisfy himself regarding the appropriateness of any adjustment or disclosure affecting the prior-period financial statements covered by his report (see section 505 in Appendix G).

Response to Subsequent Events and Subsequently Discovered Facts

.12 If, subsequent to the date of his report on audited financial statements, the auditor (including a predecessor auditor) (a) discovers, in performing the procedures described in paragraphs .10 and .11 above, subsequent events that require adjustment or disclosure in the financial statements or (b) becomes aware that facts may have existed at the date of his report that might have affected his report had he then been aware of those facts, he should follow the guidance in sections 560 and 561. If the financial statements are appropriately adjusted or the required additional disclosure is made, the auditor should follow the guidance in sections 530.05 and 530.07—.08, with respect to dating his report. If the client refuses to make appropriate adjustment or disclosure in the financial statements for a subsequent event or subsequently discovered facts, the auditor should follow the procedures in section 561.08—.09. In such circumstances, the auditor should also consider, probably with the advice of his legal counsel, withholding his consent to the use of his report on the audited financial statements in the registration statement.

.13 If an accountant concludes on the basis of facts known to him that unaudited financial statements or unaudited interim financial information presented or incorporated by reference in a registration statement are not in conformity with generally accepted accounting principles, he should insist on appropriate revision. Failing that,

- a. If the accountant has reported on a review of such interim financial information and the subsequently discovered facts are such that they would have affected his report had they been known to him at the date of his report, he should refer to section 561, because certain provisions of that section may be relevant to his consideration of those matters (see section 722.31).
- b. If the accountant has not reported on a review of the unaudited financial statements or interim financial information, he should modify his report on the audited financial statements to describe the departure from generally accepted accounting principles contained in the unaudited financial statements or interim financial information.

In either case, the accountant should also consider, probably with the advice of his legal counsel, withholding his consent to the use of his report on the audited financial statements in the registration statement.

[The next page is 1351.]

AU Section 722

Review of Interim Financial Information

Source: SAS No. 36.

See section 9722 for interpretations of this section.

Issue date, unless otherwise indicated: April, 1981.

.01 This section provides guidance on the nature, timing, and extent of procedures to be applied by the independent accountant in conducting a review of interim financial information and on the reporting applicable to such engagements.

Applicability

.02 Interim financial information may be presented alone or may accompany, or be included in a note to, audited financial statements. This section applies to reviews of interim financial information.

- a. That is presented alone, including interim financial statements and summarized interim financial data that purport to conform with the provisions of Accounting Principles Board Opinion No. 28 [AC section I73], as amended, and that is issued by a public entity to stockholders, boards of directors, or others, or contained in reports filed with regulatory agencies;¹ or
- b. That accompanies, or is included in a note to, audited financial statements of a public or nonpublic entity.

This section also provides guidance on reporting by the independent auditor when certain selected quarterly data required to be presented with audited annual financial statements by item 12(a) of Regulation S-K of the Securities and Exchange Commission (SEC) are not presented or are presented but have not been reviewed (see paragraphs .24 and .29).²

NOTE: This section supersedes section 721, *Review of Interim Financial Information*, issued in March 1979. The changes are in response to revisions of Regulation S-K of the Securities and Exchange Commission and deal with the effects on the auditor's report when interim financial information accompanies audited financial statements. The guidance in section 721, paragraphs .03 to .23 and .29 to .31, on the accountant's procedures for a review of interim financial information and the form of the accountant's review report have not been changed; they appear as paragraphs .03 to .23 and .31 to .33 of this section.

¹ For purposes of this section, a public entity is any entity (a) whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market, or (c) that is a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (a) or (b) (see section 504, *Association With Financial Statements*). For purposes of this section, the term *interim* includes financial statements or information for a twelve-month period ending on a date other than the entity's normal year-end.

² Additional considerations of the accountant relating to unaudited interim financial information presented or incorporated by reference in a filing under the Securities Act of 1933 are described in section 711, *Filings Under Federal Securities Statutes*. The accountant's involvement with such information in a comfort letter is described in section 634, *Letters for Underwriters*.

Objective of a Review of Interim Financial Information

.03 The objective of a review of interim financial information is to provide the accountant, based on objectively applying his knowledge of financial reporting practices to significant accounting matters of which he becomes aware through inquiries and analytical review procedures, with a basis for reporting whether material modifications should be made for such information to conform with generally accepted accounting principles. The objective of a review of interim financial information differs significantly from the objective of an examination of financial statements in accordance with generally accepted auditing standards. The objective of an audit is to provide a reasonable basis for expressing an opinion regarding the financial statements taken as a whole. A review of interim financial information does not provide a basis for the expression of such an opinion, because the review does not contemplate a study and evaluation of internal accounting control; tests of accounting records and of responses to inquiries by obtaining corroborating evidential matter through inspection, observation, or confirmation; and certain other procedures ordinarily performed during an audit. A review may bring to the accountant's attention significant matters affecting the interim financial information, but it does not provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit.

Procedures for a Review of Interim Financial Information

.04 The characteristics of interim financial information necessarily affect the nature, timing, and extent of procedures that the accountant may apply in making a review of that information. Timeliness is an important element of interim financial reporting. Interim financial information customarily is made available to investors and others more promptly than is annual financial information. Timely reporting of interim financial information ordinarily precludes the development of information and documentation underlying interim financial information to the same extent as that underlying annual financial information. Therefore, a characteristic of interim financial information is that many costs and expenses are estimated to a greater extent than for annual financial reporting purposes. Another characteristic of interim financial information is its relationship to annual financial information. Deferrals, accruals, and estimates at the end of each interim period are affected by judgments made at interim dates concerning anticipated results of operations for the remainder of the annual period.

.05 The procedures for a review of interim financial information are described in the following paragraphs concerning the (a) nature of procedures (paragraph .06), (b) timing of procedures (paragraph .07), and (c) extent of procedures (paragraphs .08 through .15).

Nature of Procedures

.06 Procedures for making a review of interim financial information consist primarily of inquiries and analytical review procedures concerning significant accounting matters relating to the financial information to be reported. The procedures that the accountant ordinarily should apply are

- a. Inquiry concerning (1) the accounting system, to obtain an understanding of the manner in which transactions are recorded, classified, and

(Footnote Continued)

[Reference number 634, formerly 631, changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

summarized in the preparation of interim financial information and (2) any significant changes in the system of internal accounting control, to ascertain their potential effect on the preparation of interim financial information.

- b. Application of analytical review procedures to interim financial information to identify and provide a basis for inquiry about relationships and individual items that appear to be unusual. Analytical review procedures, for purposes of this section, consist of (1) comparison of the financial information with comparable information for the immediately preceding interim period and for corresponding previous period(s), (2) comparison of the financial information with anticipated results, and (3) study of the relationships of elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience. In applying these procedures, the accountant should consider the types of matters that in the preceding year or quarters have required accounting adjustments.
- c. Reading the minutes of meetings of stockholders, board of directors, and committees of the board of directors to identify actions that may affect the interim financial information.
- d. Reading the interim financial information to consider, on the basis of information coming to the accountant's attention, whether the information to be reported conforms with generally accepted accounting principles.
- e. Obtaining reports from other accountants, if any, who have been engaged to make a review of the interim financial information of significant components of the reporting entity, its subsidiaries, or other investees.³
- f. Inquiry of officers and other executives having responsibility for financial and accounting matters concerning (1) whether the interim financial information has been prepared in conformity with generally accepted accounting principles consistently applied, (2) changes in the entity's business activities or accounting practices, (3) matters as to which questions have arisen in the course of applying the foregoing procedures, and (4) events subsequent to the date of the interim financial information that would have a material effect on the presentation of such information.
- g. Obtaining written representations from management concerning its responsibility for the financial information, completeness of minutes, subsequent events, and other matters for which the accountant believes written representations are appropriate in the circumstances. See section 333 for guidance concerning client representations.

³ When an accountant acts as principal auditor (see section 543) and makes use of the work or reports of other auditors in the course of the annual examination of his client's financial statements, he ordinarily will be in a similar position in connection with a review of interim financial information. Thus, he will require reports from other accountants as a basis, in part, for his report on his review of the consolidated interim financial information.

Timing of Procedures

.07 Adequate planning by the accountant is essential to the timely completion of a review of interim financial information. Performance of some of the work before the end of the interim period may permit the work to be carried out in a more efficient manner and to be completed at an earlier date. Performing some of the work earlier in the interim period also permits early consideration of significant accounting matters affecting the interim financial information.

Extent of Procedures

.08 The extent to which the procedures referred to in paragraph .06 are applied depends on the considerations described in paragraphs .09 through .15.

The Accountant's Knowledge of Accounting and Reporting Practices

.09 Knowledge of a client's accounting and financial reporting practices is an important factor in the performance of a review of interim financial information. An understanding of a client's practices in preparing its most recent annual financial statements provides a practical basis for the inquiry and other procedures of a review. Such an understanding can be expected to have been acquired by the accountant who has audited a client's financial statements for one or more annual periods.⁴

The Accountant's Knowledge of Weaknesses in Internal Accounting Control

.10 An accountant who has previously made an audit of his client's financial statements will have acquired knowledge concerning his client's system of internal accounting control relating to the preparation of financial statements, generally for an annual period.⁵ In these circumstances, the primary objective of the accountant's inquiries should be to identify and consider the effect of (a) changes in the system subsequent to his examination and (b) accounting control procedures used in the preparation of interim financial information that differ from those used in the preparation of annual financial statements. If the system of internal accounting control appears to contain weaknesses that do not permit preparation of interim financial information in conformity with generally accepted accounting principles, and, as a consequence, it is impracticable for the accountant to effectively apply his knowledge of financial reporting practices to the interim financial information, he should consider whether the weaknesses represent a restriction on the scope of his engagement sufficient to preclude completion of such a review (see paragraph .16). The accountant should also advise senior management and the board of directors or its audit committee of the circumstances;⁶ he may also wish to submit suggestions regarding other weaknesses in the system of internal accounting control, recommendations for improvement of interim reporting practices, and any other matters of significance that come to his attention.

The Accountant's Knowledge of Changes in Nature or Volume of Activity or Accounting Changes

.11 A review of interim financial information may bring to the accountant's attention changes in the nature or volume of the client's business activities or accounting changes. Examples of changes that could affect the interim financial information to be reported include business combinations;

⁴ If, for whatever reason, the accountant has not conducted such an audit, the need for an understanding of the client's accounting and financial reporting practices and its system of internal accounting control is not diminished. Thus, the accountant needs to consider whether, under the particular circumstances involved, he can acquire sufficient knowledge about these matters for the purposes contemplated in a review of interim financial information.

⁵ See footnote 4.

⁶ Section 323 (see Appendix G) provides guidance with respect to communicating material weaknesses in internal accounting control.

disposal of a segment of the business; extraordinary, unusual, or infrequently occurring transactions; initiation of litigation or the development of other contingencies; trends in sales or costs that could affect accounting estimates relating to the valuations of receivables and inventories, realization of deferred charges, provisions for warranties and employee benefits, and unearned income; and changes in accounting principles or in the methods of applying them. If any such changes come to the accountant's attention, he should inquire about the manner in which the changes and their effects are to be reported in the interim financial information.

Issuance of Accounting Pronouncements

.12 The accountant's knowledge of financial reporting practices is expected to include an awareness of new pronouncements on financial accounting standards. In performing a review of interim financial information he should consider the applicability of any such new pronouncements to his client's interim financial reporting practices. The accountant should also consider the applicability of existing pronouncements to new types of transactions or events that come to his attention.

Accounting Records Maintained at Multiple Locations

.13 In performing a review of interim financial information, considerations concerning locations to be visited for a client whose general accounting records are maintained at multiple locations ordinarily are similar to those involved in making an examination of the client's financial statements in accordance with generally accepted auditing standards. Usually this involves application of the foregoing procedures at both corporate headquarters and other locations selected by the accountant.

Questions Raised in Performing Other Procedures

.14 If, in performing a review of interim financial information, information comes to the accountant's attention that leads him to question whether the interim financial information to be reported conforms with generally accepted accounting principles, he should make additional inquiries or employ other procedures he considers appropriate to permit him to report on the interim financial information.

Modification of Review Procedures

.15 The procedures for a review of interim financial information may be modified, as appropriate, to take into consideration the results of auditing procedures applied in performing an examination in accordance with generally accepted auditing standards.

The Accountant's Report on a Review of Interim Financial Information

.16 An accountant may permit the use of his name and the inclusion of his report in a written communication setting forth interim financial information if he has made a review of such information as specified in the preceding paragraphs. If restrictions on the scope of a review of interim financial information preclude completion of such a review, the accountant should not permit the use of his name.⁷ Restrictions on the scope of the review may be

⁷ See paragraph .23 concerning a client's representation when the scope of a review of interim financial information has been restricted. Also, when the accountant is unable to complete such a review because of a scope limitation, he should consider the implications of that limitation with respect to the interim financial information issued by the client. In those circumstances, the

imposed by a client or caused by such circumstances as the timing of the accountant's work, an inadequacy in the accounting records, or a material weakness in internal accounting control.

Form of Accountant's Review Report

.17 The accountant's report accompanying interim financial information he has reviewed should consist of (a) a statement that the review of interim financial information was made in accordance with the standards for such reviews, (b) an identification of the interim financial information reviewed, (c) a description of the procedures for a review of interim financial information, (d) a statement that a review of interim financial information is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is an expression of opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed, and (e) a statement about whether the accountant is aware of any material modifications that should be made to the accompanying financial information so that it conforms with generally accepted accounting principles. The report may be addressed to the company, its board of directors, or its stockholders. Generally, the report should be dated as of the date of completion of the review.⁸ In addition, each page of the interim financial information should be clearly marked as "unaudited."

.18 An example of such a report follows:⁹

We have made a review of (describe the information or statements reviewed) of ABC Company and consolidated subsidiaries as of September 30, 19X1, and for the three-month and nine-month periods then ended, in accordance with standards established by the American Institute of Certified Public Accountants.

A review of interim financial information consists principally of obtaining an understanding of the system for the preparation of interim financial information, applying analytical review procedures to financial data, and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial (information or statements) for them to be in conformity with generally accepted accounting principles.

.19 The accountant may use and make reference to the report of another accountant on a review of interim financial information. This reference indicates a division of responsibility for performance of the review.¹⁰ An example of a report including such a reference follows:

(Footnote Continued)

accountant should refer to paragraphs .10, .14, and .31 for guidance on the appropriate course of action.

⁸ Other reporting issues involved in the dating of reports or concerning subsequent events are similar to those encountered in an audit of financial statements (see section 530).

⁹ If interim financial information of a prior period is presented with that of the current period and the accountant has performed a review of that information, he should report on his review of the prior period. An example of the first sentence of such a report follows: "We have made . . . of ABC Company and consolidated subsidiaries as of September 30, 19X1 and 19X2, and for the three-month and nine-month periods then ended. . . ."

¹⁰ See footnote 3.

We have made a review of (describe the information or statements reviewed) of ABC Company and consolidated subsidiaries as of September 30, 19X1, and for the three-month and nine-month periods then ended, in accordance with standards established by the American Institute of Certified Public Accountants. We were furnished with the report of other accountants on their review of the interim financial information of the ADE subsidiary, whose total assets and revenues constitute 20 percent and 22 percent respectively of the related consolidated totals.

A review of interim financial information consists principally of obtaining an understanding of the system for the preparation of interim financial information, applying analytical review procedures to financial data, and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying financial (information or statements) for them to be in conformity with generally accepted accounting principles.

Circumstances Requiring Modification of the Accountant's Review Report

.20 The circumstances that require modification of the accountant's report on a review of interim financial information arise from departures from generally accepted accounting principles, which include adequate disclosure. These circumstances differ in some respects from those that would ordinarily preclude the expression of an unqualified opinion on audited financial statements, because the report is not an expression of such an opinion. Normally, neither an uncertainty nor a lack of consistency in the application of accounting principles affecting interim financial information would cause the accountant to modify his report, provided that the interim financial information or statements appropriately disclose such matters. Modification of the accountant's report, however, would be required if a change in accounting principle is not in conformity with generally accepted accounting principles.

Departure From Generally Accepted Accounting Principles

.21 If the accountant becomes aware that the interim financial information is materially affected by a departure from generally accepted accounting principles, he should modify his report. The modification should describe the nature of the departure and, if practicable, should state the effects on the interim information. An example of such a modification of the accountant's report follows:

(Explanatory third paragraph)

Based on information furnished us by management, we believe that the company has excluded from property and debt in the accompanying balance sheet certain lease obligations that should be capitalized in order to conform with generally accepted accounting principles. This information indicates that if these lease obligations were capitalized at September 30, 19X1, property would be increased by \$—, and longterm debt by \$—, and net income and earnings per share would be increased (decreased) by \$—, \$—, \$—, and \$—, respectively for the threemonth and ninemonth periods then ended.

(Concluding paragraph)

Based on our review, with the exception of the matter(s) described in the preceding paragraph(s), we are not aware of any material modifications that should be made to the accompanying financial (information or statements) for them to be in conformity with generally accepted accounting principles.

Inadequate Disclosure

.22 The information the accountant will conclude is necessary for adequate disclosure will be influenced by the form and context in which the interim financial information is presented. For example, the disclosures considered necessary for interim financial information presented in accordance with the minimum disclosure requirements of APB Opinion No. 28, paragraph 30 [AC section 173.146], are considerably less extensive than those necessary for annual financial statements that present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.¹¹ If information that the accountant believes is necessary for adequate disclosure in conformity with generally accepted accounting principles is not included in the interim financial information, he should modify his report and, if practicable, include the necessary information. An example of such a modification of the accountant's report follows:

(Explanatory third paragraph)

Management has informed us that the company is presently contesting deficiencies in federal income taxes proposed by the Internal Revenue Service for the years 19XX through 19XY in the aggregate amount of approximately \$—, and that the extent of the company's liability, if any, and the effect on the accompanying (information or statements) are not determinable at this time. The [information or statements] fail to disclose these matters, which we believe are required to be disclosed in conformity with generally accepted accounting principles.

(Concluding paragraph)

Based on our review, with the exception of the matter(s) described in the preceding paragraph(s), we are not aware of any material modifications that should be made to the accompanying financial (information or statements) for them to be in conformity with generally accepted accounting principles.

Client's Representation Concerning a Review of Interim Financial Information

.23 The accountant may be requested to make a review of interim financial information to permit the client to include a representation to that effect in documents issued to stockholders, third parties, or in Form 10-Q, a quarterly report required to be submitted to the Securities and Exchange Commission pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934. If the client represents in such a document setting forth interim financial information that the accountant has made a review of that information, the accountant should request that his report be included.¹² If the client will not agree to include the accountant's report or if the accountant has been unable to complete the review (see paragraph .16), the accountant should

¹¹ APB Opinion No. 28, paragraph 32 [AC section 173.148], states, "... there is a presumption that users of summarized interim financial data will have read the latest published annual report, including the financial disclosures required by generally accepted accounting principles and management's commentary concerning the annual financial results, and that the summarized interim data will be viewed in that context."

¹² SEC regulations require that if the client includes a representation that the independent accountant has performed a review, the accountant's report on the review must accompany the interim financial information.

request that neither his name nor reference to him be associated with the information. If the client does not comply, the accountant should advise the client that he does not consent either to the use of his name or to reference to him and should consider what other actions might be appropriate.¹³

Interim Financial Information Accompanying Audited Financial Statements

Presentation of the Information and Application of Review Procedures

.24 Certain entities are required by item 302(a) of SEC Regulation S-K to include selected quarterly financial data in their annual reports or other documents filed with the SEC that contain audited financial statements.¹⁴ If the independent accountant has audited the financial statements of annual periods for which selected quarterly financial data specified by Regulation S-K are required to be presented, he should apply the review procedures specified in paragraphs .06 through .15 to the selected quarterly financial data. The reporting guidance in paragraph .29 is appropriate if the independent accountant has not performed such a review.

[The next page is 1361.]

¹³ In considering what actions, if any, may be appropriate in these circumstances, the accountant may wish to consult his legal counsel.

¹⁴ Item 302(a), "Supplementary Financial Information—Selected Quarterly Financial Data," states, in part, "Disclosure shall be made of net sales, gross profit . . . , income (loss) before extraordinary items and cumulative effect of a change in accounting, per share data based upon such income (loss), and net income (loss) for each full quarter within the two most recent fiscal years and any subsequent interim period for which financial statements are included or are required to be included . . ."

.25 Other entities may voluntarily include in documents containing audited financial statements the selected quarterly financial data specified in item 12(a) of SEC Regulation S-K. When an entity voluntarily includes such information, the procedures specified in paragraphs .06 through .15 are applicable unless either the entity indicates that the quarterly data have not been reviewed or the auditor expands his report on the audited financial statements to state that the data have not been reviewed (see paragraph .30).¹⁵

.26 The interim financial information ordinarily would be presented as supplementary information outside the audited financial statements. If management chooses to present the interim financial information in a note to the audited financial statements, the information should be clearly marked as unaudited.

.27 The accountant may perform the review procedures either at the time of an audit of the annual financial statements or quarterly before the issuance of the data. Performance of the procedures before issuance permits early consideration of significant accounting matters affecting the interim financial information and early modification of accounting procedures that the accountant believes might be improved. If review procedures are performed before the issuance of the quarterly data, they need not be repeated at the time an audit is performed.

Circumstances Requiring Modification of the Auditor's Report

.28 The auditor ordinarily need not modify his report on the audited financial statements to refer to his review or to the interim financial information. The interim financial information has not been audited and is not required for presentation of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Accordingly, the auditor need not report on the review of the interim financial information accompanying the audited financial statements.

Quarterly Data Required by SEC Regulation S-K

.29 The auditor's report on the audited financial statements should be expanded, however, if the selected quarterly financial data required by item 12(a) of Regulation S-K (a) are omitted or (b) have not been reviewed. For example, if the selected quarterly financial data required by item 12(a) are omitted, the auditor's report should include an additional paragraph, which might be worded as follows:

The company has not presented the selected quarterly financial data, specified by item 12(a) of Regulation S-K, that the Securities and Exchange Commission requires as supplementary information to the basic financial statements.

¹⁵ See section 551 for guidance on reporting on information accompanying the basic financial statements in auditor-submitted documents.

If the selected quarterly financial data required by item 12(a) have not been reviewed, the auditor's report should include an additional paragraph, which might be worded as follows:

The selected quarterly financial data on page xx contain information that we did not audit, and, accordingly, we do not express an opinion on that data. We attempted but were unable to review the quarterly data in accordance with standards established by the American Institute of Certified Public Accountants because we believe that the company's system for preparing interim financial information does not provide an adequate basis to enable us to complete such a review.

Voluntary or Required Presentations of Interim Financial Information

.30 The auditor's report on the audited financial statements should also be expanded when

- a. Interim financial information included in a note to the financial statements, including information that has been reviewed in accordance with the procedures specified in paragraphs .06 through .15, is not appropriately marked as unaudited;
- b. Item 12(a) information that is voluntarily presented has not been reviewed, and the information is not appropriately marked as not reviewed;
- c. The interim financial information does not appear to be presented in conformity with generally accepted accounting principles (see paragraphs .20 through .22); or
- d. The interim financial information includes an indication that a review was made but fails to state that the review is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is an expression of opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed.

The auditor need not expand his report on the audited financial statements in the circumstances described in *c* and *d* if his separate review report, which refers to those circumstances, is presented with the information.

Other Matters

.31 The accountant may conclude that interim financial information that he has reviewed and that is not to be accompanied by his report is not in conformity with generally accepted accounting principles. Also, subsequent to the date of his report, the accountant may become aware that facts existed at the date of his report that might have affected his report had he then been aware of those facts. Because of the variety of conditions that might be encountered, the specific actions to be taken by the accountant in a particular case may vary with the circumstances. In any event, the accountant would be well advised to refer to section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," because certain provisions of that

section may be relevant to his consideration of the types of matters discussed in this paragraph.

.32 A clear understanding should be established with the client regarding the nature of the services to be performed in making a review of interim financial information and the responsibilities to be assumed. Accordingly, the accountant may wish to confirm the nature and scope of his engagement in a letter to his client. The letter usually would include (a) a general description of the procedures, (b) an explanation that such procedures are substantially less in scope than an examination made in accordance with generally accepted auditing standards, and (c) a description of the form of the report.

.33 It is not possible to specify the form or the content of the working papers the accountant should prepare in connection with a review of interim financial information because of the different circumstances of individual engagements. Ordinarily, the working papers should document the performance and results of the procedures set forth in paragraph .06. See section 339, for further guidance concerning working papers. [Reference changed by the issuance of Statement on Auditing Standards No. 41.] (See section 339.)

AU Section 900

SPECIAL REPORTS OF THE COMMITTEE ON AUDITING PROCEDURE

. . . public warehouses—controls and auditing procedures for goods held . . .

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AU Section 901***Public Warehouses—Controls
and Auditing Procedures
for Goods Held***

Sources: SAS No. 1, section 901; SAS No. 43.

Issue date, unless otherwise indicated: November, 1972.

Introduction

.01 This section discusses internal controls of a public warehouse, the procedures of its independent auditor with respect to goods in the warehouse's custody, and auditing procedures performed by the independent auditor of the owner of goods in the warehouse.¹ [As amended, (by replacing paragraphs .01 through .05 with a new paragraph .01), effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

General Considerations

.02 The management of a business has the responsibility for the proper recording of transactions in its books of account, for the safeguarding of its assets, and for the substantial accuracy and adequacy of its financial statements. The independent auditor is not an insurer or guarantor; his responsibility is to express a professional opinion on the financial statements he has examined.² [Formerly paragraph .06, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Summary of Recommendations

.03 The Committee recommends that the independent auditor of the warehouseman:

- a. Make a study and evaluation of the effectiveness of both the accounting controls and the administrative controls, as defined in section 320.26—.27 (see Appendix G), relating to the accountability for and the custody of all goods placed in the warehouse.
- b. Test the warehouseman's records relating to accountability for all goods placed in his custody.
- c. Test the warehouseman's accountability under recorded outstanding warehouse receipts.
- d. Observe physical counts of the goods in custody, wherever practicable and reasonable, and reconcile his tests of such counts with records of goods stored.
- e. Confirm accountability (to the extent considered necessary) by direct communication with the holders of warehouse receipts.

¹ This section reports the conclusions of a 1966 study of the AICPA Committee on Auditing Procedure on the accountability of warehousemen for goods stored in public warehouses. [Footnote changed by issuance of Statement on Auditing Standards No. 43.]

² See section 110.

The independent auditor should apply such other procedures as he considers necessary in the circumstances. [Formerly paragraph .07, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

.04 Warehousing activities are diverse because the warehoused goods are diverse, the purposes of placing goods in custody are varied, and the scope of operations of warehouses is not uniform. The independent auditor has the responsibility to exercise his judgment in determining what procedures, including those recommended in this report, are necessary in the circumstances to afford a reasonable basis for his opinion on the financial statements.³ [Formerly paragraph .08, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.05 The following sections of this report describe those aspects of warehousing operations of primary concern to independent auditors, suggest elements of systems of internal control for warehousemen, and offer the Committee's recommendations as to procedures of the independent auditor. [Formerly paragraph .09, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Public Warehouse Operations

Types of Warehouses

.06 A warehouse may be described as a facility operated by a warehouseman whose business is the maintaining of effective custody of goods for others. [Formerly paragraph .10, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.07 Warehouses may be classified functionally as terminal warehouses or field warehouses:

Terminal Warehouse. The principal economic function of a terminal warehouse is to furnish storage. It may, however, perform other functions, including packaging and billing. It may be used to store a wide variety of goods or only a particular type of commodity.

Field Warehouse. A field warehouse is established in space leased by the warehouseman on the premises of the owner of the goods or the premises of a customer of the owner. In most circumstances all or most of the personnel at the warehouse location are employed by the warehouseman from among the employees of the owner (or customer), usually from among those who previously have been responsible for custody and handling of the goods.

³ See section 326. (Reference changed by issuance of Statement on Auditing Standards No. 31.)

Field warehousing is essentially a financing arrangement, rather than a storage operation. The warehouse is established to permit the warehouseman to take and maintain custody of goods and issue warehouse receipts to be used as collateral for a loan or other form of credit.

Warehouses may be classified also by types of goods stored. Foods and other perishable products may be stored in refrigerated warehouses, constructed and equipped to meet controlled temperature and special handling requirements. Certain bulk commodities, such as various agricultural products and chemicals, are stored in commodity warehouses; these warehouses often are designed and equipped to store only one commodity, and fungible goods frequently are commingled without regard to ownership. A wide variety of goods, usually not requiring special storage facilities, is stored in general merchandise warehouses. Some warehouses confine their activities to storing furniture, other household goods, and personal effects. [Formerly paragraph .11, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Warehouse Receipts

.08 A basic document in warehousing is the warehouse receipt. The Uniform Warehouse Receipts Act and Article 7 of the Uniform Commercial Code regulate the issuance of warehouse receipts, prescribe certain terms that must be contained in such receipts, provide for their negotiation and transfer, and establish the rights of receipt holders. The Uniform Commercial Code has been adopted by a majority of the states, and the Uniform Warehouse Receipts Act is in force in all states where the Code has not been adopted. [Formerly paragraph .12, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.09 Warehouse receipts may be in negotiable form or non-negotiable form and may be used as evidence of collateral for loans or other forms of credit. Goods represented by a negotiable warehouse receipt may be released only upon surrender of the receipt to the warehouseman for cancellation or endorsement, whereas goods represented by a non-negotiable receipt may be released upon valid instructions without the need for surrender of the receipt. Other important ways in which the two kinds of receipts differ concern the manner in which the right of possession to the goods they represent may be transferred from one party to another and the rights acquired by bona fide purchasers of the receipts. [Formerly paragraph .13, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.10 Since goods covered by non-negotiable receipts may be released without surrender of the receipts, such outstanding receipts are not necessarily an indication of accountability on the part of the warehouseman or of evidence of ownership by the depositor. Since goods are frequently withdrawn piecemeal, the warehouseman's accountability at any given time is for the quantity of goods for which receipts have been issued minus the

quantities released against properly authorized withdrawals. [Formerly paragraph .14, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.11 The Uniform Warehouse Receipts Act and Article 7 of the Uniform Commercial Code, in addition to their provisions with respect to the issuance and contents of warehouse receipts, contain provisions with respect to, among other things, the storage and release of warehoused goods, the standard of care to be exercised by the warehouseman, warehouseman's liability, and liens for the warehouseman's charges and expenses and the manner in which they may be enforced. [Formerly paragraph .15, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Government Regulation

.12 There are various other statutes and regulations, applicable in special situations, relating to the rights and duties of warehousemen and the operation of warehouses. Among the more important are (a) the United States Warehouse Act and the regulations adopted thereunder by the Department of Agriculture, providing for licensing and regulation of warehouses storing certain agricultural commodities, (b) the regulations adopted by commodity exchanges licensed under the United States Commodity Exchange Act, providing for issuance and registration of receipts and licensing and regulation of warehouses, and (c) the Internal Revenue Code and the Tariff Act of 1930, and regulations adopted thereunder, relating respectively to United States Revenue Bonded Warehouses and United States Customs Bonded Warehouses, providing for licensing, bonding, and regulation of such warehouses. In addition, there are statutes and regulations in various states relating to licensing, bonding, insurance, and other matters. [Formerly paragraph .16, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

The Warehouseman

Internal Controls

.13 Goods held in custody for others are not owned by the warehouseman and, therefore, do not appear as assets in his financial statements. Similarly, the related custodial responsibility does not appear as a liability. However, as in other businesses, the warehouseman is exposed to the risk of loss or claims for damage stemming from faulty performance of his operating functions. Faulty performance may take the form of loss or improper release of goods, improper issuance of warehouse receipts, failure to maintain effective custody of goods so that lenders' preferential liens are lost, and other forms. [Formerly paragraph .17, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.14 In the broad sense, the internal controls of a business may be characterized as either accounting or administrative. Accounting controls

generally bear directly and importantly on the reliability of the financial records and, therefore, require evaluation by the independent auditor. Administrative controls are concerned mainly with operational efficiency and adherence to managerial policies. Administrative controls ordinarily relate only indirectly to the financial records and, therefore, would not require evaluation by the auditor. However, if the auditor believes that certain administrative controls may have an important bearing on the reliability of the financial records, he should consider the need for evaluating such controls. The recommendation herein that the independent auditor of the warehouseman make a study and evaluation of administrative controls is based upon the important relationship of such controls to the custodial responsibilities of the warehouseman, which are not reflected in his financial statements. Significant unrecorded liabilities may arise if these custodial responsibilities are not discharged properly. [Formerly paragraph .18, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.15 Whether and to what extent the suggested control procedures that follow may be applicable to a particular warehouse operation will depend on the nature of the operation, of the goods stored, and of the warehouseman's organization. Appropriate segregation of duties in the performance of the respective operating functions should be emphasized.

Receiving, Storing, and Delivering Goods

Receipts should be issued for all goods admitted into storage.

Receiving clerks should prepare reports as to all goods received. The receiving report should be compared with quantities shown on bills of lading or other documents received from the owner or other outside sources by an employee independent of receiving, storing, and shipping.

Goods received should be inspected, counted, weighed, measured, or graded in accordance with applicable requirements. There should be a periodic check of the accuracy of any mechanical facilities used for these purposes.

Unless commingling is unavoidable, such as with fungible goods, goods should be stored so that each lot is segregated and identified with the pertinent warehouse receipt. The warehouse office records should show the location of the goods represented by each outstanding receipt.

Instructions should be issued that goods may be released only on proper authorization which, in the case of negotiable receipts, includes surrender of the receipt.

Access to the storage area should be limited to those employees whose duties require it, and the custody of keys should be controlled.

Periodic statements to customers should identify the goods held and request that discrepancies be reported to a specified employee who is not connected with receiving, storing, and delivery of goods.

The stored goods should be physically counted or tested periodically, and quantities agreed to the records by an employee independent of the storage function; the extent to which this is done may depend on the nature of the goods, the rate of turnover, and the effectiveness of other control procedures.

Where the goods held are perishable, a regular schedule for inspection of condition should be established.

Protective devices such as burglar alarms, fire alarms, sprinkler systems, and temperature and humidity controls should be inspected regularly.

Goods should be released from the warehouse only on the basis of written instructions received from an authorized employee who does not have access to the goods.

Counts of goods released as made by stock clerks should be independently checked by shipping clerks or others and the two counts should be compared before the goods are released.

Warehouse Receipts

Prenumbered receipt forms should be used, and procedures established for accounting for all forms used and for cancellation of negotiable receipts when goods have been delivered.

Unused forms should be safeguarded against theft or misuse and their custody assigned to a responsible employee who is not authorized to prepare or sign receipts.

Receipt forms should be furnished only to authorized persons, and in a quantity limited to the number required for current use.

The signer of receipts should ascertain that the receipts are supported by receiving records or other underlying documents.

Receipts should be prepared and completed in a manner designed to prevent alteration.

Authorized signers should be a limited number of responsible employees.

Insurance

The adequacy, as to both type and amount, of insurance coverage carried by the warehouseman should be reviewed at appropriate intervals.

[Formerly paragraph .19, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Additional Control Procedures for Field Warehouses

.16 As indicated earlier, the purpose of field warehousing differs from terminal warehousing. Operating requirements also may differ because a field

warehouseman may operate at a large number of locations. [Formerly paragraph .20, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.17 In field warehousing, controls are applied at two points: the field location and the warehouseman's central office. At the field location, the control procedures as to receipt, storage, and delivery of goods and issuance of warehouse receipts generally will comprise the procedures suggested above, with such variations as may be appropriate in light of the requirements, and available personnel, at the respective locations. Only non-negotiable warehouse receipts should be issued from field locations, and the receipt forms should be furnished to the field locations by the central office in quantities limited to current requirements. [Formerly paragraph .21, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.18 The central office should investigate and approve the field warehousing arrangements, and exercise control as to custody and release of goods and issuance of receipts at the field locations. Control procedures suggested for the central office are the following:

Consideration of the business reputation and financial standing of the depositor.

Preparation of a field warehouse contract in accordance with the particular requirements of the depositor and the lender.

Determination that the leased warehouse premises meet the physical requirements for segregation and effective custody of goods.

Satisfaction as to legal matters relative to the lease of the warehouse premises.

Investigation and bonding of the employees at the field locations.

Providing employees at field locations with written instructions covering their duties and responsibilities.

Maintenance of inventory records at the central office showing the quantity (and stated value, where applicable) of goods represented by each outstanding warehouse receipt.

Examination of the field warehouse by representatives of the central office. These examinations would include inspection of the facilities, observation as to compliance with prescribed procedures, physical counts or tests of goods in custody and reconciliation of quantities to records at the central office and at field locations, accounting for all receipt forms furnished to the field locations, and confirmation (on a test basis, where appropriate) of outstanding warehouse receipts with the registered holders.

[Formerly paragraph .22, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Procedures of the Independent Auditor

.19 The Committee recommends that the independent auditor of the warehouseman:

- a. Make a study and evaluation of the effectiveness of both the accounting controls and the administrative controls, as defined in section 320.26—.27 (see Appendix G), relating to the accountability for and the custody of all goods placed in the warehouse.
- b. Test the warehouseman's records relating to accountability for all goods placed in his custody.
- c. Test the warehouseman's accountability under recorded outstanding warehouse receipts.
- d. Observe physical counts of the goods in custody, wherever practicable and reasonable, and reconcile his tests of such counts with records of goods stored.
- e. Confirm accountability (to the extent considered necessary) by direct communication with the holders of warehouse receipts.

The independent auditor should apply such other procedures as he considers necessary in the circumstances. [Formerly paragraph .23, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

.20 The auditor's procedures relating to accountability might include, on a test basis, comparison of documentary evidence of goods received and delivered with warehouse receipts records, accounting for issued and unissued warehouse receipts by number, and comparison of the records of goods stored with billings for storage. In some circumstances, the auditor may consider it necessary to obtain confirmation from the printer as to the serial numbers of receipt forms supplied. [Formerly paragraph .24, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

.21 In the case of a field warehouseman where goods are stored at many scattered locations, the independent auditor may satisfy himself that the warehouseman's physical count procedures are adequate by observing the procedures at certain selected locations. The amount of testing required will be dependent upon the uniformity and adequacy of the internal controls. [Formerly paragraph .25, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.22 The confirmation of negotiable receipts with holders may be impracticable, since the identity of the holders usually is not known to the warehouseman. Confirmation with the depositor to whom the outstanding receipt was originally issued, however, would be evidential matter of the accountability for certain designated goods. It should be recognized, too, that as to both negotiable and non-negotiable receipts, confirmation may not be conclusive in the light of the possibility of issued but unrecorded receipts. In some circumstances, it may be desirable to request confirmations from former depositors who are not currently holders of record. [Formerly paragraph .26, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.23 The independent auditor should review the nature and extent of the warehouseman's insurance coverage and the adequacy of any reserves for losses under damage claims. [Formerly paragraph .27, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Controls and Auditing Procedures for Owner's Goods Stored in Public Warehouses

.24 The following paragraphs provide guidance on the elements of internal control for the owner of the goods and on the auditing procedures to be employed by his independent auditor. [As amended, (formerly paragraph .28) effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

Internal Controls

.25 The internal controls of the owner should be designed to provide reasonable safeguards over his goods in a warehouseman's custody. Ordinarily, the controls should include an investigation of the warehouseman before the goods are placed in custody, and a continuing evaluation of the warehouseman's performance in maintaining custody of the goods. [Formerly paragraph .29, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.26 Among the suggested control procedures that may be comprehended in an investigation of the warehouseman before the goods are placed in his custody are the following:

Consideration of the business reputation and financial standing of the warehouseman.

Inspection of the physical facilities.

Inquiries as to the warehouseman's control procedures and whether the warehouseman holds goods for his own account.

Inquiries as to type and adequacy of the warehouseman's insurance.

Inquiries as to government or other licensing and bonding requirements and the nature, extent, and results of any inspection by government or other agencies.

Review of the warehouseman's financial statements and related reports of independent auditors. [Formerly paragraph .30, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.27 After the goods are placed in the warehouse, suggested control procedures that may be applied periodically by the owner in evaluating the warehouseman's performance in maintaining custody of goods include the following:

Review and update the information developed from the investigation described above.

Physical counts (or test counts) of the goods, wherever practicable and reasonable (may not be practicable in the case of fungible goods).

Reconciliation of quantities shown on statements received from the warehouseman with the owner's records.

In addition, he should review his own insurance, if any, on goods in the custody of the warehouseman. [Formerly paragraph .31, number changed by

issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Procedures of the Independent Auditor

.28 Section 331.14, describes the procedures that the auditor should apply if inventories are held in public warehouses. [As amended, (formerly paragraph .32) by Statement on Auditing Standards No. 43, effective after August 31, 1982.]

AU Section 2000

STATEMENTS ON STANDARDS
FOR ATTESTATION
ENGAGEMENTS

These Statements are issued by the Auditing Standards Board, the Accounting and Review Services Committee, and the Management Advisory Services Executive Committee under the authority granted them by the Council of the Institute to interpret rule 201, General Standards, of the Institute's Code of Professional Ethics. Members should be prepared to justify departures from this Statement.

... attestation standards ... interpretations of
attestation standards

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ATTESTATION STANDARDS

Introduction

The accompanying "attestation standards" provide guidance and establish a broad framework for a variety of attest services increasingly demanded of the accounting profession. The standards and related interpretive commentary are designed to provide professional guidelines that will enhance both consistency and quality in the performance of such services.

For years, attest services generally were limited to expressing a positive opinion on historical financial statements on the basis of an examination in accordance with generally accepted auditing standards (GAAS). However, certified public accountants increasingly have been requested to provide, and have been providing, assurance on representations other than historical financial statements and in forms other than the positive opinion. In responding to these needs, certified public accountants have been able to generally apply the basic concepts underlying GAAS to these attest services. As the range of attest services has grown, however, it has become increasingly difficult to do so.

Consequently, the main objective of adopting these attestation standards and the related interpretive commentary is to provide a general framework for and set reasonable boundaries around the attest function. As such, the standards and commentary (a) provide useful and necessary guidance to certified public accountants engaged to perform new and evolving attest services and (b) guide AICPA standard-setting bodies in establishing, if deemed necessary, interpretive standards for such services.

The attestation standards are a natural extension of the ten generally accepted auditing standards. Like the auditing standards, the attestation standards deal with the need for technical competence, independence in mental attitude, due professional care, adequate planning and supervision, sufficient evidence, and appropriate reporting; however, they are much broader in scope. (The eleven attestation standards are listed below.) Such standards apply to a growing array of attest services. These services include, for example, reports on descriptions of systems of internal accounting control; on descriptions of computer software; on compliance with statutory, regulatory, and contractual requirements; on investment performance statistics; and on information supplementary to financial statements. Thus,

the standards have been developed to be responsive to a changing environment and the demands of society.

These attestation standards apply only to attest services rendered by a certified public accountant in the practice of public accounting—that is, a practitioner as defined in footnote 1 of paragraph .01.

The attestation standards do not supersede any of the existing standards in Statements on Auditing Standards (SASs), Statements on Standards for Accounting and Review Services (SSARs), and Statement on Standards for Accountants' Services on Prospective Financial Information. Therefore, the practitioner who is engaged to perform an engagement subject to these existing standards should follow such standards.

Attestation Standards

General Standards

1. The engagement shall be performed by a practitioner or practitioners having adequate technical training and proficiency in the attest function.
2. The engagement shall be performed by a practitioner or practitioners having adequate knowledge in the subject matter of the assertion.
3. The practitioner shall perform an engagement only if he or she has reason to believe that the following two conditions exist:
 - The assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them.
 - The assertion is capable of reasonably consistent estimation or measurement using such criteria.
4. In all matters relating to the engagement, an independence in mental attitude shall be maintained by the practitioner or practitioners.
5. Due professional care shall be exercised in the performance of the engagement.

Standards of Fieldwork

1. The work shall be adequately planned and assistants, if any, shall be properly supervised.
2. Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.

Standards of Reporting

1. The report shall identify the assertion being reported on and state the character of the engagement.
 2. The report shall state the practitioner's conclusion about whether the assertion is presented in conformity with the established or stated criteria against which it was measured.
 3. The report shall state all of the practitioner's significant reservations about the engagement and the presentation of the assertion.
 4. The report on an engagement to evaluate an assertion that has been prepared in conformity with agreed-upon criteria or on an engagement to apply agreed-upon procedures should contain a statement limiting its use to the parties who have agreed upon such criteria or procedures.
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➤ *The next page is 1511.* ←

AU Section 2010

Attestation Standards

See section 2011 for interpretations of this section.

Effective for attest reports issued on or after September 30, 1986, unless otherwise indicated.

Attest Engagement

.01 When a certified public accountant in the practice of public accounting¹ (herein referred to as “a practitioner”) performs an attest engagement, as defined below, the engagement is subject to the attestation standards and related interpretive commentary in this pronouncement and to any other authoritative interpretive standards that apply to the particular engagement.²

An attest engagement is one in which a practitioner is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written assertion³ that is the responsibility of another party.⁴

.02 Examples of professional services typically provided by practitioners that would not be considered attest engagements include—

- a. Management consulting engagements in which the practitioner is engaged to provide advice or recommendations to a client.
- b. Engagements in which the practitioner is engaged to advocate a client’s position—for example, tax matters being reviewed by the Internal Revenue Service.
- c. Tax engagements in which a practitioner is engaged to prepare tax returns or provide tax advice.
- d. Engagements in which the practitioner compiles financial statements, because he is not required to examine or review any evidence

¹ A “certified public accountant in the practice of public accounting” includes any of the following who perform or assist in the attest engagement: (1) an individual public accountant; (2) a proprietor, partner, or shareholder in a public accounting firm; (3) a full- or part-time employee of a public accounting firm; and (4) an entity (for example, partnership, corporation, trust, joint venture, or pool) whose operating, financial, or accounting policies can be significantly influenced by one of the persons described in (1) through (3) or by two or more of such persons if they choose to act together.

² Existing authoritative standards that might apply to a particular attest engagement include SASs, SSARSs, and Statement on Standards for Accountants’ Services on Prospective Financial Information. In addition, authoritative interpretive standards for specific types of attest engagements, including standards concerning the subject matter of the assertions presented, may be issued in the future by authorized AICPA senior technical committees. Furthermore, when a practitioner undertakes an attest engagement for the benefit of a government body or agency and agrees to follow specified government standards, guides, procedures, statutes, rules, and regulations, the practitioner is obliged to follow this section and the applicable authoritative interpretive standards as well as those governmental requirements.

³ An *assertion* is any declaration, or set of related declarations taken as a whole, by a party responsible for it.

⁴ The term *attest* and its variants, such as *attesting* and *attestation*, are used in a number of state accountancy laws, and in regulations issued by State Boards of Accountancy under such laws, for different purposes and with different meanings from those intended by this section. Consequently, the definition of *attest engagement* set out in this paragraph, and the attendant meaning of *attest* and *attestation* as used throughout the section should not be understood as defining these terms, and similar terms, as they are used in any law or regulation, nor as embodying a common understanding of the terms which may also be reflected in such laws or regulations.

supporting the information furnished by the client and does not express any conclusion on its reliability.

- e. Engagements in which the practitioner's role is solely to assist the client—for example, acting as the company accountant in preparing information other than financial statements.
- f. Engagements in which a practitioner is engaged to testify as an expert witness in accounting, auditing, taxation, or other matters, given certain stipulated facts.
- g. Engagements in which a practitioner is engaged to provide an expert opinion on certain points of principle, such as the application of tax laws or accounting standards, given specific facts provided by another party so long as the expert opinion does not express a conclusion about the reliability of the facts provided by the other party.

.03 The practitioner who does not explicitly express a conclusion about the reliability of an assertion that is the responsibility of another party should be aware that there may be circumstances in which such a conclusion could be reasonably inferred. For example, if the practitioner issues a report that includes an enumeration of procedures that could reasonably be expected to provide assurance about an assertion, the practitioner may not be able to avoid the inference that the report is an attest report merely by omitting an explicit conclusion on the reliability of the assertion.

.04 The practitioner who has assembled or assisted in assembling an assertion should not claim to be the asserter if the assertion is materially dependent on the actions, plans, or assumptions of some other individual or group. In such a situation, that individual or group is the “asserter,” and the practitioner will be viewed as an attester if a conclusion about the reliability of the assertion is expressed.

.05 An attest engagement may be part of a larger engagement—for example, a feasibility study or business acquisition study that includes an examination of prospective financial information. In such circumstances, these standards apply only to the attest portion of the engagement.

General Standards

.06 The first general standard is—*The engagement shall be performed by a practitioner or practitioners having adequate technical training and proficiency in the attest function.*

.07 Performing attest services is different from preparing and presenting an assertion. The latter involves collecting, classifying, summarizing, and

communicating information; this usually entails reducing a mass of detailed data to a manageable and understandable form. On the other hand, performing attest services involves gathering evidence to support the assertion and objectively assessing the measurements and communications of the asserter. Thus, attest services are analytical, critical, investigative, and concerned with the basis and support for the assertions.

.08 The attainment of proficiency as an attester begins with formal education and extends into subsequent experience. To meet the requirements of a professional, the attester's training should be adequate in technical scope and should include a commensurate measure of general education.

.09 The second general standard is—*The engagement shall be performed by a practitioner or practitioners having adequate knowledge in the subject matter of the assertion.*

.10 A practitioner may obtain adequate knowledge of the subject matter to be reported on through formal or continuing education, including self-study, or through practical experience. However, this standard does not necessarily require a practitioner to personally acquire all of the necessary knowledge in the subject matter to be qualified to judge an assertion's reliability. This knowledge requirement may be met, in part, through the use of one or more specialists on a particular attest engagement if the practitioner has sufficient knowledge of the subject matter (a) to communicate to the specialist the objectives of the work and (b) to evaluate the specialist's work to determine if the objectives were achieved.

.11 The third general standard is—*The practitioner shall perform an engagement only if he or she has reason to believe that the following two conditions exist:*

- a. *The assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them.*
- b. *The assertion is capable of reasonably consistent estimation or measurement using such criteria.*

.12 The attest function should be performed only when it can be effective and useful. Practitioners should have a reasonable basis for believing that a meaningful conclusion can be provided on an assertion.

.13 The first condition requires an assertion to have reasonable criteria against which it can be evaluated. Criteria promulgated by a body designated by Council under the AICPA Code of Professional Ethics are, by definition, considered to be reasonable criteria for this purpose. Criteria issued by regulatory agencies and other bodies composed of experts that follow due-process procedures, including procedures for broad distribution of proposed criteria for public comment, normally should also be considered reasonable criteria for this purpose.

.14 However, criteria established by industry associations or similar groups that do not follow due process or do not as clearly represent the public

interest should be viewed more critically. Although established and recognized in some respects, such criteria should be considered similar to measurement and disclosure criteria that lack authoritative support, and the practitioner should evaluate whether they are reasonable. Such criteria should be stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for knowledgeable readers to be able to understand them.

.15 Reasonable criteria are those that yield useful information. The usefulness of information depends on an appropriate balance between relevance and reliability. Consequently, in assessing the reasonableness of measurement and disclosure criteria, the practitioner should consider whether the assertions generated by such criteria have an appropriate balance of the following characteristics.

a. Relevance

- *Capacity to make a difference in a decision*—The assertions are useful in forming predictions about the outcomes of past, present, and future events or in confirming or correcting prior expectations.
- *Ability to bear upon uncertainty*—The assertions are useful in confirming or altering the degree of uncertainty about the result of a decision.
- *Timeliness*—The assertions are available to decision makers before they lose their capability to influence decisions.
- *Completeness*—The assertions do not omit information that could alter or confirm a decision.
- *Consistency*—The assertions are measured and presented in materially the same manner in succeeding time periods or (if material inconsistencies exist) changes are disclosed, justified, and, where practical, reconciled to permit proper interpretations of sequential measurements.

b. Reliability

- *Representational faithfulness*—The assertions correspond or agree with the phenomena they purport to represent.
- *Absence of unwarranted inference of certainty or precision*—The assertions may sometimes be presented more appropriately through the use of ranges or indications of the probabilities attaching to different values rather than as single point estimates.
- *Neutrality*—The primary concern is the relevance and reliability of the assertions rather than their potential effect on a particular interest.
- *Freedom from bias*—The measurements involved in the assertions are equally likely to fall on either side of what they represent rather than more often on one side than the other.

.16 Some criteria are reasonable in evaluating a presentation of assertions for only a limited number of specified users who participated in their establishment. For instance, criteria set forth in a purchase agreement for the

preparation and presentation of financial statements of a company to be acquired, when materially different from generally accepted accounting principles (GAAP), are reasonable only when reporting to the parties to the agreement.

.17 Even when reasonable criteria exist, the practitioner should consider whether the assertion is also capable of reasonably consistent estimation or measurement using those criteria.⁵ Competent persons using the same or similar measurement and disclosure criteria ordinarily should be able to obtain materially similar estimates or measurements. However, competent persons will not always reach the same conclusion because (a) such estimates and measurements often require the exercise of considerable professional judgment and (b) a slightly different evaluation of the facts could yield a significant difference in the presentation of a particular assertion. An assertion estimated or measured using criteria promulgated by a body designated by Council under the AICPA Code of Professional Ethics is considered, by definition, to be capable of reasonably consistent estimation or measurement.

.18 A practitioner should not provide assurance on an assertion that is so subjective (for example, the “best” software product from among a large number of similar products) that people having competence in and using the same or similar measurement and disclosure criteria would not ordinarily be able to obtain materially similar estimates or measurements. A practitioner’s assurance on such an assertion would add no real credibility to the assertion; consequently, it would be meaningless at best and could be misleading.

.19 The second condition does not presume that all competent persons would be expected to select the same measurement and disclosure criteria in developing a particular estimate or measurement (for example, the provision for depreciation on plant and equipment). However, assuming the same measurement and disclosure criteria were used (for example, the straight-line method of depreciation), materially similar estimates or measurements would be expected to be obtained.

.20 Furthermore, for the purpose of assessing whether particular measurement and disclosure criteria can be expected to yield reasonably consistent estimates or measurements, materiality must be judged in light of the expected range of reasonableness for a particular assertion. For instance, “soft” information, such as forecasts or projections, would be expected to have a wider range of reasonable estimates than “hard” data, such as the quantity of a particular item of inventory existing at a specific location.

.21 The second condition applies equally whether the practitioner has been engaged to perform an “examination” or a “review” of a presentation of assertions (see the second reporting standard). Consequently, it is inappropriate to perform a review engagement where the practitioner concludes that an examination cannot be performed because competent persons using the same or similar measurement and disclosure criteria would

⁵ Criteria may yield quantitative or qualitative estimates or measurements.

not ordinarily be able to obtain materially similar estimates or measurements. For example, practitioners should not provide negative assurance on the assertion that a particular software product is the “best” among a large number of similar products because they could not provide the highest level of assurance (a positive opinion) on such an assertion (were they engaged to do so) because of its inherent subjectivity.

.22 The fourth general standard is—*In all matters relating to the engagement, an independence in mental attitude shall be maintained by the practitioner or practitioners.*

.23 The practitioner should maintain the intellectual honesty and impartiality necessary to reach an unbiased conclusion about the reliability of an assertion. This is a cornerstone of the attest function. Consequently, practitioners performing an attest service should not only be independent in fact, but also should avoid situations that may impair the appearance of independence.

.24 In the final analysis, independence means objective consideration of facts, unbiased judgments, and honest neutrality on the part of the practitioner in forming and expressing conclusions. It implies not the attitude of a prosecutor but a judicial impartiality that recognizes an obligation for fairness. Independence presumes an undeviating concern for an unbiased conclusion about the reliability of an assertion no matter what the assertion may be.

.25 The fifth general standard is—*Due professional care shall be exercised in the performance of the engagement.*

.26 Due care imposes a responsibility on each practitioner involved with the engagement to observe each of the attestation standards. Exercise of due care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report.

.27 *Cooley on Torts*, a treatise that has stood the test of time, describes a professional’s obligation for due care as follows:

Every man who offers his services to another and is employed, assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon mere errors of judgment.⁶

⁶ 3 D. Haggard, *Cooley on Torts*, 472 (4th ed., 1932).

Standards of Fieldwork

.28 The first standard of fieldwork is—*The work shall be adequately planned and assistants, if any, shall be properly supervised.*

.29 Proper planning and supervision contribute to the effectiveness of attest procedures. Proper planning directly influences the selection of appropriate procedures and the timeliness of their application, and proper supervision helps ensure that planned procedures are appropriately applied.

.30 Planning an attest engagement involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners need to have sufficient knowledge to enable them to understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on the presentation of the assertions.

.31 Factors to be considered by the practitioner in planning an attest engagement include (a) the presentation criteria to be used, (b) the anticipated level of attestation risk ⁷ related to the assertions on which he or she will report, (c) preliminary judgments about materiality levels for attest purposes, (d) the items within a presentation of assertions that are likely to require revision or adjustment, (e) conditions that may require extension or modification of attest procedures, and (f) the nature of the report expected to be issued.

.32 The nature, extent, and timing of planning will vary with the nature and complexity of the assertions and the practitioner's prior experience with the asserter. As part of the planning process, the practitioner should consider the nature, extent, and timing of the work to be performed to accomplish the objectives of the attest engagement. Nevertheless, as the attest engagement progresses, changed conditions may make it necessary to modify planned procedures.

.33 Supervision involves directing the efforts of assistants who participate in accomplishing the objectives of the attest engagement and determining whether those objectives were accomplished. Elements of supervision include instructing assistants, staying informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion among personnel. The extent of supervision appropriate in a given instance depends on many factors, including the nature and complexity of the subject matter and the qualifications of the persons performing the work.

.34 Assistants should be informed of their responsibilities, including the objectives of the procedures that they are to perform and matters that may affect the nature, extent, and timing of such procedures. The practitioner with final responsibility for the engagement should direct assistants to bring to his or her attention significant questions raised during the attest engagement so that their significance may be assessed.

⁷ *Attestation risk* is the risk that the practitioner may unknowingly fail to appropriately modify his or her attest report on an assertion that is materially misstated. It consists of (a) the risk (consisting of inherent risk and control risk) that the assertion contains errors that could be material and (b) the risk that the practitioner will not detect such errors (detection risk).

.35 The work performed by each assistant should be reviewed to determine if it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the practitioner's report.

.36 The second standard of fieldwork is—*Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.*

.37 Selecting and applying procedures that will accumulate evidence that is sufficient in the circumstances to provide a reasonable basis for the level of assurance to be expressed in the attest report requires the careful exercise of professional judgment. A broad array of available procedures may be applied in an attest engagement. In establishing a proper combination of procedures to appropriately restrict attestation risk, the practitioner should consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to important exceptions.

- a. Evidence obtained from independent sources outside an entity provides greater assurance of an assertion's reliability than evidence secured solely from within the entity.
- b. Information obtained from the independent attester's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.
- c. Assertions developed under effective internal controls are more reliable than those developed in the absence of internal controls.

.38 Thus, in the hierarchy of available attest procedures, those that involve search and verification (for example, inspection, confirmation, or observation), particularly when using independent sources outside the entity, are generally more effective in reducing attestation risk than those involving internal inquiries and comparisons of internal information (for example, analytical procedures and discussions with individuals responsible for the assertion). On the other hand, the latter are generally less costly to apply.

.39 In an attest engagement designed to provide the highest level of assurance on an assertion (an "examination"), the practitioner's objective is to accumulate sufficient evidence to limit attestation risk to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report. In such an engagement, a practitioner should select from all available procedures—that is, procedures that assess inherent and control risk and restrict detection risk—any combination that can limit attestation risk to such an appropriately low level.

.40 In a limited assurance engagement (a "review"), the objective is to accumulate sufficient evidence to limit attestation risk to a moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures).

.41 Nevertheless, there will be circumstances when inquiry and analytical procedures (a) cannot be performed, (b) are deemed less efficient than other

procedures, or (c) yield evidence indicating that the assertion may be incomplete or inaccurate. In the first circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided. In the second circumstance, the practitioner may perform other procedures that he or she believes would be more efficient to provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would provide. In the third circumstance, the practitioner should perform additional procedures.

.42 The extent to which attestation procedures will be performed should be based on the level of assurance to be provided and the practitioner's consideration of (a) the nature and materiality of the information to the presentation of assertions taken as a whole, (b) the likelihood of misstatements, (c) knowledge obtained during current and previous engagements, (d) the asserter's competence in the subject matter of the assertion, (e) the extent to which the information is affected by the asserter's judgment, and (f) inadequacies in the asserter's underlying data.

.43 This standard also covers engagements designed solely to meet the needs of specified users who have participated in establishing the nature and scope of the engagement. In connection with those engagements, the practitioner is required to perform only those procedures that have been designed or agreed to by such users. Specified users include persons and entities who have participated in establishing the nature and scope of the attest engagement either directly or through a designated representative (for example, a lawyer, lead underwriter, trustee, or supervisory government agency).

.44 The practitioner's procedures generally may be as limited or extensive as the specified users desire; however, mere reading of the assertions does not constitute a procedure sufficient to permit a practitioner to report on the results of applying agreed-upon procedures to a presentation of assertions.

Standards of Reporting

.45 The first standard of reporting is—*The report shall identify the assertion being reported on and state the character of the engagement.*

.46 The practitioner who accepts an attest engagement should issue a report on the assertions or withdraw from the attest engagement. When a report is issued, the assertions should be identified by referring to a separate presentation of assertions that is the responsibility of the asserter. The presentation of assertions should generally be bound with or accompany the practitioner's report. Because the asserter's responsibility for the assertions should be clear, it is ordinarily not sufficient merely to include the assertions in the practitioner's report.

.47 The statement of the character of an attest engagement that is designed to result in a general-distribution report includes two elements: (a) a description of the nature and scope of the work performed and (b) a reference

to the professional standards governing the engagement. When the form of the statement is prescribed in authoritative interpretive standards (for example, an examination in accordance with GAAS), that form should be used in the practitioner's report. However, when no such interpretive standards exist, (1) the terms *examination* and *review* should be used to describe engagements to provide, respectively, the highest level and a moderate level of assurance, and (2) the reference to professional standards should be accomplished by referring to "standards established by the American Institute of Certified Public Accountants."

.48 The statement of the character of an attest engagement in which the practitioner applies agreed-upon procedures should refer to conformity with the arrangements made with the specified user(s). Such engagements are designed to accommodate the specific needs of the parties in interest and should be described by identifying the procedures agreed upon by such parties.

.49 The second standard of reporting is—*The report shall state the practitioner's conclusion about whether the assertion is presented in conformity with the established or stated criteria against which it was measured.*

.50 The practitioner should consider the concept of materiality in applying this standard. In expressing a conclusion on the conformity of a presentation of assertions with established or stated criteria, the practitioner should consider the omission or misstatement of an individual assertion to be material if the magnitude of the omission or misstatement—individually or when aggregated with other omissions or misstatements—is such that a reasonable person relying on the presentation of assertions would be influenced by the inclusion or correction of the individual assertion. The relative, rather than absolute, size of an omission or misstatement determines whether it is material in a given situation.

.51 General-distribution attest reports should be limited to two levels of assurance: one based on a reduction of attestation risk to an appropriately low level (an "examination") and the other based on a reduction of attestation risk to a moderate level (a "review").

.52 In an engagement to achieve the highest level of assurance (an "examination"), the practitioner's conclusion should be expressed in the form of a positive opinion. When attestation risk has been reduced only to a moderate level (a "review"), the conclusion should be expressed in the form of negative assurance.

Examination

.53 When expressing a positive opinion, the practitioner should clearly state whether, in his or her opinion, the presentation of assertions is presented in conformity with established or stated criteria. Reports expressing a positive opinion on a presentation of assertions taken as a whole, however, may be qualified or modified for some aspect of the presentation or the engagement

(see the third reporting standard). In addition, such reports may emphasize certain matters relating to the attest engagement or the presentation of assertions.

.54 The following is an illustration of an examination report that expresses an unqualified opinion on a presentation of assertions, assuming that no specific report form has been prescribed in authoritative interpretive standards.

We have examined the accompanying *[identify the presentation of assertions—for example, Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 19X1]*. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

[Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the presentation of assertions.]

In our opinion, the *[identify the presentation of assertions—for example, Statement of Investment Performance Statistics]* referred to above presents *[identify the assertion—for example, the investment performance of XYZ Fund for the year ended December 31, 19X1]* in conformity with *[identify established or stated criteria—for example, the measurement and disclosure criteria set forth in Note 1]*.

.55 When the presentation of assertions has been prepared in conformity with specified criteria that have been agreed upon by the assenter and the user, the practitioner's report should also contain—

- a. A statement of limitations on the use of the report because it is intended solely for specified parties (see the fourth reporting standard).
- b. An indication, when applicable, that the presentation of assertions differs materially from that which would have been presented if criteria for the presentation of such assertions for general distribution had been followed in its preparation (for example, financial statements prepared in accordance with criteria specified in a contractual arrangement may differ materially from statements prepared in conformity with GAAP).

Review

.56 In providing negative assurance, the practitioner's conclusion should state whether any information came to the practitioner's attention on the basis of the work performed that indicates that the assertions are not presented in all material respects in conformity with established or stated criteria. (As discussed more fully in the commentary to the third reporting standard, if the assertions are not modified to correct for any such information that comes to the practitioner's attention, such information should be described in the practitioner's report.)

.57 A practitioner's negative assurance report may also comment on or emphasize certain matters relating to the attest engagement or the presentation of assertions. Furthermore, the practitioner's report should—

- a. Indicate that the work performed was less in scope than an examination.
- b. Disclaim a positive opinion on the assertions.
- c. Contain the additional statements noted in paragraph .55 when the presentation of assertions has been prepared in conformity with specified criteria that have been agreed upon by the assenter and user(s).

.58 The following is an illustration of a review report that expresses negative assurance where no exceptions have been found, assuming that no specific report form has been prescribed in authoritative interpretive standards:

We have reviewed the accompanying [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 19X1*]. Our review was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics*]. Accordingly, we do not express such an opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the presentation of assertions.*]

Based on our review, nothing came to our attention that caused us to believe that the accompanying [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics*] is not presented in conformity with [*identify the established or stated criteria—for example, the measurement and disclosure criteria set forth in Note 1*].

Agreed-Upon Procedures

.59 A practitioner's conclusion on the results of applying agreed-upon procedures to a presentation of assertions should be in the form of a summary of findings, negative assurance, or both. Furthermore, the practitioner's report should contain—

- a. A statement of limitations on the use of the report because it is intended solely for the use of specified parties (see the fourth reporting standard).
- b. A summary or list of the specific procedures performed (or reference thereto) to notify the reader what the reported findings or negative assurance are based on.

.60 A practitioner's report on the application of agreed-upon procedures ordinarily should also indicate that the work performed was less in scope than an examination and disclaim a positive opinion on the assertions. Furthermore, when the presentation of assertions has been prepared in

conformity with specified criteria that have been agreed upon by the assertor and user(s), the practitioner's report should, when applicable, contain an indication that the presentation of assertions differs materially from that which would have been presented if criteria for the presentation of such assertions for general distribution had been followed in its preparation.

.61 The level of assurance provided in a report on the application of agreed-upon procedures depends on the nature and scope of the practitioner's procedures as agreed upon with the specified parties to whom the report is restricted. Furthermore, such parties must understand that they take responsibility for the adequacy of the attest procedures (and, therefore, the amount of assurance provided) for their purposes.

.62 The following is an illustration of an agreed-upon procedures report where the procedures are enumerated rather than referred to and where both a summary of findings and negative assurance are included. Either the summary of findings, if no exceptions are found, or negative assurance could be omitted.

To ABC Inc. and XYZ Fund

We have applied the procedures enumerated below to the accompanying [identify the presentation of assertions—for example, *Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 19X1*]. These procedures, which were agreed to by ABC Inc. and XYZ Fund, were performed solely to assist you in evaluating [identify the assertion—for example, *the investment performance of XYZ Fund*]. This report is intended solely for your information and should not be used by those who did not participate in determining the procedures.

[Include paragraph to enumerate procedures and findings.]

These agreed-upon procedures are substantially less in scope than an examination, the objective of which is the expression of an opinion on the [identify the presentation of assertions—for example, *Statement of Investment Performance Statistics*]. Accordingly, we do not express such an opinion.

Based on the application of the procedures referred to above, nothing came to our attention that caused us to believe that the accompanying [identify the presentation of assertions—for example, *Statement of Investment Performance Statistics*] is not presented in conformity with [identify the established, stated, or agreed-upon criteria—for example, *the measurement and disclosure criteria set forth in Note 1*]. Had we performed additional procedures or had we made an examination of the [identify the presentation of assertions—for example, *Statement of Investment Performance Statistics*], other matters might have come to our attention that would have been reported to you.

.63 The third standard of reporting is—*The report shall state all of the practitioner's significant reservations about the engagement and the presentation of the assertion.*

.64 "Reservations about the engagement" refers to any unresolved problem that the practitioner had in complying with the these attestation standards, interpretive standards, or the specific procedures agreed to by the specific user(s). The practitioner should not express an unqualified conclusion unless the engagement has been conducted in accordance with the attestation standards. Such standards will not have been complied with if the practitioner has been unable to apply all the procedures that he or she considers necessary in the circumstances or, when applicable, that have been agreed upon with the user(s).

.65 Restrictions on the scope of an engagement, whether imposed by the client or by such other circumstances as the timing of the work or the inability to obtain sufficient evidence, may require the practitioner to qualify the assurance provided, to disclaim any assurance, or to withdraw from the engagement. The reasons for a qualification or disclaimer should be described in the practitioner's report.

.66 The practitioner's decision to provide qualified assurance, to disclaim any assurance, or to withdraw because of a scope limitation depends on an assessment of the effect of the omitted procedure(s) on his or her ability to express assurance on the presentation of assertions. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question, by their significance to the presentation of assertions, and by whether the engagement is an examination or a review. If the potential effects relate to many assertions within a presentation of assertions or if the practitioner is performing a review, a disclaimer of assurance or withdrawal is more likely to be appropriate. When restrictions that significantly limit the scope of the engagement are imposed by the client, the practitioner generally should disclaim any assurance on the presentation of assertions or withdraw from the engagement.

.67 "Reservations about the presentation of assertions" refers to any unresolved reservation about the conformity of the presentation with established or stated criteria, including the adequacy of the disclosure of material matters. They can result in either a qualified or an adverse report depending on the materiality of the departure from the criteria against which the assertions were evaluated.

.68 Reservations about the presentation of assertions may relate to the measurement, form, arrangement, content, or underlying judgments and assumptions applicable to the presentation of assertions and its appended notes, including, for example, the terminology used, the amount of detail given, the classification of items, and the bases of amounts set forth. The practitioner considers whether a particular reservation should be the subject of a qualified report or adverse report given the circumstances and facts of which he or she is aware at the time.

.69 The fourth standard of reporting is—*The report on an engagement to evaluate an assertion that has been prepared in conformity with agreed-upon criteria or on an engagement to apply agreed-upon procedures should contain*

a statement limiting its use to the parties who have agreed upon such criteria or procedures.

.70 Certain reports should be restricted to specified users who have participated in establishing either the criteria against which the assertions were evaluated (which are not deemed to be “reasonable” for general distribution—see the third general standard) or the nature and scope of the attest engagement. Such procedures or criteria can be agreed upon directly by the user or through a designated representative. Reports on such engagements should clearly indicate that they are intended solely for the use of the specified parties and may not be useful to others.

Attest Services Related to MAS Engagements

Attest Services as Part of an MAS Engagement

.71 When a practitioner⁸ provides an attest service (as defined in this section) as part of an MAS engagement, the Statements on Standards for Attestation Engagements⁹ apply only to the attest service. Statements on Standards for Management Advisory Services (SSMASs) apply to the balance of the MAS engagement.¹⁰ [New paragraph added, effective for attest reports issued on or after May 1, 1988, by SSAE, *Attest Services Related to MAS Engagements*.]

.72 When the practitioner determines that an attest service is to be provided as part of an MAS engagement, the practitioner should inform the client of the relevant differences between the two types of services and obtain concurrence that the attest service is to be performed in accordance with the appropriate professional requirements. The MAS engagement letter or an amendment should document the requirement to perform an attest service. The practitioner should take such actions because the professional requirements for an attest service differ from those for a management advisory service. [New paragraph added, effective for attest reports issued on or after May 1, 1988, by SSAE, *Attest Services Related to MAS Engagements*.]

.73 The practitioner should issue separate reports on the attest engagement and the MAS engagement and, if presented in a common binder, the report on the attest engagement or service should be clearly identified and segregated from the report on the MAS engagement. [New paragraph added, effective for attest reports issued on or after May 1, 1988, by SSAE, *Attest Services Related to MAS Engagements*.]

Assertions, Criteria, and Evidence

.74 An attest service may involve written assertions, evaluation criteria, or evidential matter developed during a concurrent or prior MAS engagement. A written assertion of another party developed with the practitioner's advice and assistance as the result of such an MAS engagement may be the subject of an attestation engagement, provided the assertion is dependent upon the actions, plans, or assumptions of that other party who is in a position to have

⁸ *Practitioner* is defined in this section to include a proprietor, partner, or shareholder in a public accounting firm and any full- or part-time employee of a public accounting firm, whether certified or not.

⁹ This refers to the SSAE *Attestation Standards* and subsequent statements in that series, as issued by the AICPA.

¹⁰ This refers to SSMA No. 1, *Definitions and Standards for MAS Practice* [MS section 11], and subsequent statements in that series, as issued by the AICPA.

an informed judgment about its accuracy. Criteria developed with the practitioner's assistance may be used to evaluate an assertion in an attest engagement, provided such criteria meet the requirements in this section. Relevant information obtained in the course of a concurrent or prior MAS engagement may be used as evidential matter in an attest engagement, provided the information satisfies the requirements of this section. [New paragraph added, effective for attest reports issued on or after May 1, 1988, by SSAE, *Attest Services Related to MAS Engagements*.]

Nonattest Evaluations of Written Assertions

.75 The evaluation of statements contained in a written assertion of another party when performing a management advisory service does not in and of itself constitute the performance of an attest service. For example, in the course of an engagement to help a client select a computer that meets the client's needs, the practitioner may evaluate written assertions from one or more vendors, performing some of the same procedures as required for an attest service. However, the MAS report will focus on whether the computer meets the client's needs, not on the reliability of the vendor's assertions. Also, the practitioner's study of the computer's suitability will not be limited to what is in the written assertions of the vendors. Some or all of the information provided in the vendors' written proposals, as well as other information, will be evaluated to recommend a system suitable to the client's needs. Such evaluations are necessary to enable the practitioner to achieve the purpose of the MAS engagement. [New paragraph added, effective for attest reports issued on or after May 1, 1988, by SSAE, *Attest Services Related to MAS Engagements*.]

Effective Date

.76 Paragraphs .01 through .70 are effective for attest reports issued on or after September 30, 1986. Earlier application is encouraged. Paragraphs .71 through .75 are effective for attest reports issued on or after May 1, 1988. [As amended, effective for attest reports issued on or after May 1, 1988, by Statement on Standards for Attestation Engagements, *Attest Services Related to MAS Engagements*. Formerly paragraph .71, number changed by the issuance of SSAE, *Attest Services Related to MAS Engagements*.]

Appendix A

.77 Comparison of the Attestation Standards With Generally Accepted Auditing Standards

1. Two principal conceptual differences exist between the attestation standards and the ten existing GAAS. First, the attestation standards provide a framework for the attest function beyond historical financial statements. Accordingly, references to “financial statements” and “generally accepted accounting principles,” which exist in GAAS, are omitted from the attestation standards. Second, as is apparent in the standards of fieldwork and reporting, the attestation standards accommodate the growing number of attest services in which the practitioner expresses assurances below the level that is expressed for the traditional audit (“positive opinion”).

2. In addition to these two major differences, another conceptual difference exists. The attestation standards formally provide for attest services that are tailored to the needs of users who have participated in establishing either the nature and scope of the attest engagement or the specialized criteria against which the assertions are to be measured, and who will thus receive a limited-use report. Although these differences are substantive, they merely recognize changes that have already occurred in the marketplace and in the practice of public accounting.

3. As a consequence of these three conceptual differences, the composition of the attestation standards differs from that of GAAS. The compositional differences, as indicated in the table at the end of this Appendix, fall into two major categories: (a) two general standards not contained in GAAS are included in the attestation standards and (b) one of the fieldwork standards and two of the reporting standards in GAAS are not explicitly included in the attestation standards. Each of these differences is described in the remainder of this Appendix.

4. Two new general standards are included because, together with the definition of an attest engagement, they establish appropriate boundaries around the attest function. Once the subject matter of attestation extends beyond historical financial statements, there is a need to determine just how far this extension of attest services can and should go. The boundaries set by the attestation standards require (a) that the practitioner have adequate knowledge in the subject matter of the assertion (the second general standard) and (b) that the assertion be capable of reasonably consistent estimation or measurement using established or stated criteria (the third general standard).

5. The second standard of fieldwork in GAAS is not included in the attestation standards for a number of reasons. That standard calls for “a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.” The most important reason for not including this standard is that the second standard of fieldwork of the attestation standards encompasses the study and evaluation of internal controls because, when performed, it is an element of accumulating sufficient evidence. A second reason is that the concept of internal control may not be relevant for certain assertions (for example, aspects of information about computer software) on which a practitioner may be engaged to report.

6. The attestation standards of reporting are organized differently from the GAAS reporting standards to accommodate matters of emphasis that naturally evolve from an expansion of the attest function to cover more than one level and form of assurance on a variety of presentations of assertions. There is also a new reporting theme in the attestation standards. This is the limitation of the use of certain reports to specified users and is a natural extension of the acknowledgement that the attest function should accommodate engagements tailored to the needs of specified parties who have partici-

pated in establishing either the nature and scope of the engagement or the specified criteria against which the assertions were measured.

7. In addition, two reporting standards in GAAS have been omitted from the attestation standards. The first is the standard that requires the auditor's report to state "whether such [accounting] principles have been consistently observed in the current period in relation to the preceding period." The second states that "informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report." Those two standards are not included in the attestation standards because the second attestation standard of reporting, which requires a conclusion about whether the assertions are presented in conformity with established or stated criteria, encompasses both of these omitted standards.

Attestation Standards Compared With Generally Accepted Auditing Standards

Attestation Standards

Generally Accepted Auditing Standards

General Standards

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|---|--|
| <ol style="list-style-type: none"> 1. The engagement shall be performed by a practitioner or practitioners having adequate technical training and proficiency in the attest function. 2. The engagement shall be performed by a practitioner or practitioners having adequate knowledge in the subject matter of the assertion. 3. The practitioner shall perform an engagement only if he or she has reason to believe that the following two conditions exist: <ul style="list-style-type: none"> ● The assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them. ● The assertion is capable of reasonably consistent estimation or measurement using such criteria. 4. In all matters relating to the engagement, an independence in mental attitude shall be maintained by the practitioner or practitioners. 5. Due professional care shall be exercised in the performance of the engagement. | <ol style="list-style-type: none"> 1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor. 2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors. 3. Due professional care is to be exercised in the performance of the examination and the preparation of the report. |
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Standards of Fieldwork

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|---|--|
| <ol style="list-style-type: none"> 1. The work shall be adequately planned and assistants, if any, shall be properly supervised. | <ol style="list-style-type: none"> 1. The work is to be adequately planned and assistants, if any, are to be properly supervised. 2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance |
|---|--|

- thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
2. Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.
 3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall identify the assertion being reported on and state the character of the engagement.
 2. The report shall state the practitioner's conclusion about whether the assertion is presented in conformity with the established or stated criteria against which it was measured.
 3. The report shall state all of the practitioner's significant reservations about the engagement and the presentation of the assertion.
 4. The report on an engagement to evaluate an assertion that has been prepared in conformity with agreed-upon criteria or on an engagement to apply agreed-upon procedures should contain a statement limiting its use to the parties who have agreed upon such criteria or procedures.
1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
 2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
 3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
 4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

[Formerly paragraph .72, number changed by the issuance of SSAE, *Attest Services Related to MAS Engagements*, effective for attest reports issued on or after May 1, 1988.]

Appendix B

.78 Analysis of Apparent or Possible Inconsistencies Between the Attestation Standards and Existing SASs and SSARs

1. There are no identified inconsistencies between the attestation standards and the ten generally accepted auditing standards or those SASs that deal with audits of historical financial statements. However, certain existing interpretive standards (SASs and SSARs) and audit and accounting guides that pertain to other attest services are modestly inconsistent with these attestation standards. The purpose of this Appendix is to identify apparent or possible inconsistencies between the attestation standards and existing SASs and SSARs. It provides appropriate standard-setting bodies with a list of matters that may require their attention. The Auditing Standards Board and the Accounting and Review Services Committee will evaluate apparent or possible inconsistencies and consider whether any changes are necessary. The decision to propose changes, if any, to existing pronouncements will be the subject of the regular due-process procedures of AICPA standard-setting bodies.

2. The specific SASs, SSARs, and other pronouncements in which apparent or possible inconsistencies exist (in whole or in part) have been classified into the following broad categories to assist readers in understanding and evaluating their potential significance:

- a. Exception reporting
- b. Failure to report on conformity with established or stated criteria
- c. Failure to refer to a separate presentation of assertions that is the responsibility of the assertor
- d. Lack of appropriate scope of work for providing a moderate level of assurance
- e. Report wording inconsistencies

All existing authoritative pronouncements will remain in force while the Auditing Standards Board and the Accounting and Review Services Committee evaluate these apparent or possible inconsistencies.

Exception Reporting

3. Certain SASs (Nos. 27, 28, 36, 40, and 45 [sections 553; 554; 722; 556; and 313, 334, and 557, respectively]) require the auditor to apply certain limited procedures to supplementary information required by the Financial Accounting Standards Board (FASB) but to separately report on such information only if exceptions arise. The purpose of these limited procedures is to permit the auditor to reach a conclusion on the reliability of required supplementary information; consequently, this seems to amount to an attest service in the broadest sense of that term. However, because the auditor has not been engaged to express and normally does not express a conclusion in this particular circumstance, the limited procedures do not fully meet the definition of an attest engagement.

Failure to Report on Conformity With Established or Stated Criteria

4. SAS Nos. 29 and 42 [sections 551 and 552] provide guidance for auditors when they report on two specific types of assertions: information accompanying financial statements in an auditor-submitted document and condensed financial information, respectively. The apparent criterion against which the auditor is directed to report is whether the assertion is "fairly

stated in all material respects in relation to the basic financial statements taken as a whole."

5. To some, such a form of reporting seems to be inconsistent with the second reporting standard, which requires the practitioner's report to state "whether the assertions are presented in conformity with the established or stated criteria against which they were measured." Although it seems reasonably clear that GAAP are the established criteria against which the information accompanying financial statements in an auditor-submitted document is evaluated, the report form required by SAS No. 29 [section 551] does not specifically refer to GAAP. Such reference, if it were required, would effectively reduce the stated level of materiality from the "financial statements as a whole" to the specific assertions on which the practitioner is reporting, and a practitioner may not have obtained sufficient evidence to provide a positive opinion on the assertions in such a fashion.

6. The situation with respect to SAS No. 42 [section 552] is somewhat different. Although some would argue that there are established criteria (for example, GAAP or Securities and Exchange Commission [SEC] regulations) for condensed financial statements and selected financial information, others do not agree with such a conclusion. The Auditing Standards Board took the latter position when this SAS was adopted because it did not provide for a reference to GAAP or SEC regulations in the standard auditor's report.

Failure to Refer to a Separate Presentation of Assertions That Is the Responsibility of the Asserter

7. SAS Nos. 14 and 30 [sections 621 and 642] provide for attest reports in which there is no reference to a separate presentation of assertions by the responsible party. In both cases, management's assertions—compliance with regulatory or contractual requirements and the adequacy of the entity's system of internal accounting control—are, at best, implied or contained in a management representation letter.

8. For instance, SAS No. 30 [section 642] refers to an engagement to express an opinion on an entity's system of internal accounting control rather than on management's description of such a system (including its evaluation of the system's adequacy). Furthermore, the standard report gives the practitioner's opinion directly on the system. In an effort to better place the responsibility for the system where it really lies, the report does include some additional explanatory paragraphs that contain statements about management's responsibility and the inherent limitations of internal controls.

Lack of Appropriate Scope of Work for Providing a Moderate Level of Assurance

9. Portions of three SASs (SAS No. 14 [section 621], on compliance with regulatory or contractual requirements; SAS No. 29 [section 551], on information accompanying financial statements in an auditor-submitted document; and SAS No. 30 [section 642], on a system of internal accounting control based on a financial statement audit) permit the expression of limited assurance on specific assertions based solely or substantially on those auditing procedures that happen to have been applied in forming an opinion on a separate assertion—the financial statements taken as a whole.

10. Such a basis for limited assurance seems inconsistent with the second fieldwork standard, which requires that limited assurance on a specific assertion must be based either on obtaining sufficient evidence to reduce attestation risk to a moderate level as described in the attestation standards or applying specific procedures that have been agreed upon by specified users for their benefit. The scope of work performed on the specific assertions covered in the three SASs identified above depends entirely, or to a large extent, on what happens to be done in the audit of another assertion and would not seem to satisfy the requirements of either of the bases for limited assurance provided in the second standard of fieldwork.

11. Four other SASs (Nos. 27, 28, 40, and 45 [sections 553; 554; 556; and 313, 334, and 557, respectively]) may be inconsistent with the requirements of the second fieldwork standard in that they prescribe procedures as a basis for obtaining limited assurance on a specific assertion that seem to constitute a smaller scope than those necessary to reduce attestation risk to a moderate level. These SASs either limit the prescribed procedures to specific inquiries or the reading of an assertion, or they acknowledge that an auditor may not be able to perform inquiries to resolve doubts about certain assertions.

Report Wording Inconsistencies

12. The four reporting standards require that an attest report contain specific elements, such as an identification of the assertions, a statement of the character of the engagement, a disclaimer of positive opinion in limited assurance engagements, and the use of negative assurance wording in such engagements. A number of existing SASs and SSARs prescribe reports that do not contain some of these elements.

13. Because a compilation of financial statements as described in the SSARs and a compilation of prospective financial statements as described in the Statement on Standards for Accountants' Services on Prospective Financial Information [section 2100] do not result in the expression of a conclusion on the reliability of the assertions contained in those financial statements, they are not attest engagements. Therefore, such engagements do not have to comply with the attestation standards and there can be no inconsistencies. Although it does not involve the attest function, a compilation is nevertheless a valuable professional service involving a practitioner's expertise in putting an entity's financial information into the form of financial statements—an accounting (subject matter) expertise rather than attestation expertise.

14. Certain existing reporting and other requirements of SASs and SSARs go beyond (but are not contrary to) the standards. Examples include the requirements to perform a study and evaluation of internal control, to report on consistency in connection with an examination of financial statements, and to withdraw in a review of financial statements when there is a scope limitation. These requirements remain in force.

[Formerly paragraph .73, number changed by the issuance of SSAE, *Attest Services Related to MAS Engagements*, effective for attest reports issued on or after May 1, 1988.]

[The next page is 1541.]

AU Section 2011***Interpretation of Attestation
Standards: Defense Industry
Questionnaire on Business
Ethics and Conduct***

The staff of the Auditing Standards Division has been authorized to issue interpretations to provide timely guidance on the application of pronouncements of the Auditing Standards Board. Interpretations are reviewed by members of that Board. An interpretation is not as authoritative as a pronouncement of the Auditing Standards Board, but members should be aware that they may have to justify a departure from an interpretation if the quality of their work is questioned.

.01 Question—Certain defense contractors have made a commitment to adopt and implement six principles of business ethics and conduct contained in the *Defense Industry Initiatives on Business Ethics and Conduct (Initiatives)*. One of those principles concerns defense contractors' public accountability for their commitment to the Initiatives. That principle requires completion of a *Questionnaire on Business Ethics and Conduct (Questionnaire)*, which is appended to the six principles.

.02 The public accountability principle also requires the defense contractor's independent public accountant or similar independent organization to express a conclusion about the responses to the *Questionnaire* and issue a report thereon for submission to the External Independent Organization of the Defense Industry (EIODI). (Appendixes C and D to this Interpretation [paragraphs .24 and .25] provide background information about the *Initiatives*, the six principles, and the required *Questionnaire*.)

.03 A defense contractor may request its independent public accountant (practitioner) to examine or review its responses to the *Questionnaire* for the purpose of expressing a conclusion about the appropriateness of those responses in a report prepared for general distribution. Would such an engagement be an attest engagement as defined in Statement on Standards for Attestation Engagements, *Attestation Standards (SSAE)* [section 2010]?

.04 Interpretation—SSAE [section 2010] defines an attest engagement as one in which a practitioner is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. The questions in the *Questionnaire* and the accompanying responses are written assertions of the defense contractor. When a practitioner is engaged by a defense contractor to express a written conclusion about the appropriateness of those responses, such an engagement involves a written conclusion about the reliability of an assertion that is the responsibility of the defense contractor. Consequently, SSAE [section 2010] applies to such engagements.

.05 Question—Paragraph 11 of SSAE [section 2010.11] specifies that a practitioner shall perform an attest engagement only if there are reasons to believe that “the assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them.” What are the criteria against which such assertions are to be evaluated and do such criteria provide a reasonable basis for the general distribution of the presentation of the assertions and a practitioner’s report thereon?

.06 Interpretation—The criteria for evaluating the defense contractor’s assertions are set forth in the *Initiatives* and *Questionnaire*. The reasonableness of those criteria must be evaluated by assessing whether the assertions they generate (the questions and responses in the *Questionnaire*) have an appropriate balance of the relevance and reliability characteristics discussed in paragraph 15 of SSAE [section 2010.15].

.07 The criteria set forth in the *Initiatives* and *Questionnaire* will, when properly applied, generate assertions that have an appropriate balance of relevance and reliability. Consequently, such criteria provide a reasonable basis for the general distribution of the *Questionnaire* and responses and the practitioner’s report thereon. Although the criteria provide a reasonable basis for general distribution of the practitioner’s report, they have not been established by the type of recognized body contemplated in paragraph 13 of SSAE [section 2010.13]. Consequently, as required by paragraph 14 of SSAE [section 2010.14], the criteria must be stated in the presentation of assertions in a sufficiently clear and comprehensive manner for a knowledgeable reader to understand them. This requirement will be satisfied if the defense contractor attaches the *Initiatives* and *Questionnaire* to the presentation of the assertions.

.08 Question—What is the nature of the procedures that should be applied to the *Questionnaire* responses?

.09 Interpretation—The objective of the procedures performed in either an examination or review engagement is to obtain evidential matter that the defense contractor has designed and placed in operation policies and programs that conform with the criteria in the *Initiatives* and *Questionnaire* in a manner that supports the responses to the questions in the *Questionnaire* and that the policies and programs operated during the period covered by the defense contractor’s assertion. The objective does not include providing assurance about whether the defense contractor’s policies and programs operated effectively to ensure compliance with the defense contractor’s code of business ethics and conduct on the part of individual employees or about whether the defense contractor and its employees have complied with federal procurement laws. In an examination, the evidential matter should be sufficient to limit the attestation risk for the assertions to a level that is appropriately low for the high degree of assurance imparted by an examination report. In a review, this evidential matter should be sufficient to limit the attestation risk to a moderate level.

.10 Examination procedures include obtaining evidential matter by reading relevant policies and programs, making inquiries of appropriate defense contractor personnel, inspecting documents and records, confirming defense contractor assertions with its employees or others, and observing activities. Illustrative examination procedures are presented in Appendix A [paragraph .22]. Review procedures are generally limited to reading relevant policies and procedures and making inquiries of appropriate defense contractor personnel. Illustrative review procedures are presented in Appendix E [paragraph .26].

When applying examination or review procedures, the practitioner should assess the appropriateness (including the comprehensiveness) of the policies and programs in meeting the criteria in the *Initiatives* and *Questionnaire*.

.11 A particular defense contractor's policies and programs may vary from those of other defense contractors. As a result, evidential matter obtained from the procedures performed cannot be evaluated solely on a quantitative basis. Consequently, it is not practicable to establish only quantitative guidelines for determining the nature or extent of the evidential matter that is necessary to provide the assurance required in either an examination or review. The qualitative aspects should also be considered.

.12 In an examination it will be necessary for a practitioner's procedures to go beyond reading relevant policies and programs and making inquiries of appropriate defense contractor personnel to determine whether the policies and programs that support a defense contractor's answers to specific questions in the *Questionnaire* operated during the period.

.13 In determining the nature, timing, and extent of examination or review procedures, the practitioner should consider information obtained in the performance of other services for the defense contractor, for example, the audit of the defense contractor's financial statements. For multi-location defense contractors, whether policies and programs operated during the period should be evaluated for both the defense contractor's headquarters and for selected defense contracting locations. The practitioner may consider using the work of the defense contractor's internal auditors. The guidance in AU Section 322, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination*, may be useful in that consideration.

.14 Examination procedures, and in some instances review procedures, may require access to information involving specific instances of actual or alleged noncompliance with laws. An inability to obtain access to such information because of restrictions imposed by a defense contractor (for example, to protect attorney-client privilege) may constitute a scope limitation. Paragraphs 63 through 66 of SSAE [section 2010.63—.66] provide guidance in such situations. The practitioner should assess the effect of the inability to obtain access to such information on his or her ability to form a conclusion about whether the related policy or program operated during the period. If the defense contractor's reasons for not permitting access to the information are reasonable (for example, the information is the subject of litigation or a governmental investigation) and have been approved by an executive officer of the defense contractor, the occurrences of restricted access to information are few in number, and the practitioner has access to other information about that specific instance or about other instances that is sufficient to permit a conclusion to be formed about whether the related policy or program operated during the period, the practitioner ordinarily would conclude that it is not necessary to disclaim assurance.

.15 If the practitioner's scope of work has been restricted with respect to one or more questions, the practitioner should consider the implications of that restriction on the practitioner's ability to form a conclusion about other questions. In addition, as the nature or number of questions on which the defense contractor has imposed scope limitations increases in significance, the practitioner should consider whether to withdraw from the engagement.

.16 *Question*—What is the form of report that should be issued to meet the requirements of SSAE [section 2010]?

.17 *Interpretation*—The standards of reporting in SSAE (paragraphs 45 through 70 [section 2010.45—.70]) provide guidance about report content and

wording and the circumstances that may require report modification. Appendix B and Appendix F [paragraphs .23 and .27] provide illustrative reports appropriate for various circumstances. Paragraph 46 [section 2010.46] states that the practitioner's report should refer to a separate presentation of assertions that is the responsibility of the asserter. The completed *Questionnaire* constitutes the presentation of assertions that should be referred to in the practitioner's report. The defense contractor should prepare a statement to accompany the presentation of the completed *Questionnaire* that asserts that the responses to the *Questionnaire* are appropriately presented in conformity with the criteria. An illustrative defense contractor statement is also presented in Appendix B and Appendix F.

.18 The engagements addressed in this Interpretation do not include providing assurance about whether the defense contractor's policies and programs operated effectively to ensure compliance with the defense contractor's code of business ethics and conduct on the part of individual employees or about whether the defense contractor and its employees have complied with federal procurement laws. The practitioner's report should explicitly disclaim an opinion on the extent of such compliance.

.19 Because variations in individual performance and interpretation will affect the operation of the defense contractor's policies and programs during the period, adherence to all such policies and programs in every case may not be possible. In determining whether a reservation about a response in the *Questionnaire* is sufficiently significant to result in an opinion modified for an exception to that response, the practitioner should consider the nature, causes, patterns, and pervasiveness of the instances in which the policies and programs did not operate as designed and their implications for that response in the *Questionnaire*.

.20 When scope limitations have precluded the practitioner from forming an opinion on the responses to one or more questions, the practitioner's report should describe all such scope restrictions. If such a scope limitation was imposed by the defense contractor after the practitioner had begun performing procedures, that fact should be stated in the report.

.21 A defense contractor may request the practitioner to communicate to management, the board of directors, or one of its committees, either orally or in writing, conditions noted that do not constitute significant reservations about the answers to the *Questionnaire* but that might nevertheless be of value to management. Agreed-upon arrangements between the practitioner and the defense contractor to communicate conditions noted may include, for example, the reporting of matters of less significance than those contemplated by the criteria stated in the *Initiatives* and *Questionnaire*, the existence of conditions specified by the defense contractor, the results of further investigation of matters noted to identify underlying causes, or suggestions for improvements in various policies or programs. Under these arrangements, the practitioner may be requested to visit specific locations, assess the effectiveness of specific policies or programs, or undertake specific attestation procedures not otherwise planned. In addition, the practitioner is not precluded from communicating matters believed to be of value, even if no specific request has been made.

Appendix A

.22 Illustrative Procedures for Examination of Answers to Questionnaire

Defense Industry Questionnaire on Business Ethics and Conduct

Before performing procedures, the practitioner should read the *Defense Industry Initiatives on Business Ethics and Conduct*.

1. Does the Company have a written Code of Business Ethics and Conduct?

Determine whether the Company has a written Code of Business Ethics and Conduct.

2. Is the Code distributed to all employees principally involved in defense work?

- a. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company distributes the Code to all employees principally involved in defense work.

- b. Obtain additional evidential matter, by positive confirmation of a selected number of employees or by other means, that the Code was distributed to employees principally involved in defense work.

3. Are new employees provided any orientation to the Code?

- a. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company provides an orientation to the Code to new employees.

- b. Obtain additional evidential matter, by positive confirmation of a selected number of employees hired during the reporting period or by other means, that an orientation to the Code was provided at time of employment.

4. Does the Code assign responsibility to operating management and others for compliance with the Code?

Read the Code to determine whether it includes (a) the assignment of responsibility for compliance with the Code to operating management and others, and (b) a statement of the standards that govern the conduct of all employees in their relationships to the Company.

5. Does the Company conduct employee training programs regarding the Code?

- a. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company conducts training programs regarding the Code.

- b. Obtain additional evidential matter, by positive confirmation of a selected number of employees or by other means, that the Company conducted employee training programs regarding the Code for employees principally involved in defense work.

6. Does the Code address standards that govern the conduct of employees in their dealings with suppliers, consultants and customers?

Read the Code to determine whether it addresses standards that govern the conduct of employees in their dealings with suppliers, consultants, and customers.

7. Is there a corporate review board, ombudsman, corporate compliance or ethics office or similar mechanism for employees to report suspected violations to someone other than their direct supervisor, if necessary?

Determine by inquiry of Company officials, observation, and/or by reading relevant documentation whether a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism exists for employees to report suspected violations.

8. Does the mechanism employed protect the confidentiality of employee reports?
 - a. Determine by inquiry of members of the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism established by the Company whether they understand the need to protect the confidentiality of employee reports.
 - b. Determine by inquiry of Company officials and/or by reading relevant documentation how the procedures employed protect this confidentiality.
9. Is there an appropriate mechanism to follow-up on reports of suspected violations to determine what occurred, who was responsible, and recommended corrective and other actions?
 - a. Determine by inquiry of Company officials and/or by reading relevant documentation how the follow-up procedures established by the Company operate and whether an appropriate mechanism exists to follow-up on reports of suspected violations reported to a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism to determine what occurred, who was responsible, and recommended corrective and other action.
 - b. Determine by inquiry of those responsible for performing such follow-up procedures how they document that the procedures were carried out.
 - c. Obtain additional evidential matter that the follow-up mechanism was employed by examining a selected number of reports of suspected violations from the log or other record of reports used by the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism.
10. Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?
 - a. Determine by inquiry of Company officials and/or by reading relevant documentation whether an appropriate mechanism exists for letting employees know the result of any follow-up into their reported charges.
 - b. For those items selected at Question 9 above, determine by inquiry of members of the corporate review board,

ombudsman, corporate compliance or ethics office, or similar mechanism and by examining other evidential matter whether the results of the Company's follow-up of reported charges have been communicated to employees.

11. Is there an ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the Code of conduct?

and
12. What are the specifics of such a program?
 - A. Written communication?
 - B. One-on-one communication?
 - C. Group meetings?
 - D. Visual aids?
 - E. Others?
 - a. Determine by inquiry of Company officials and/or by reading relevant documentation the extent of the Company's ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the Code. Note the specific means of communication and compare to the Company's response to Question 12 of the *Questionnaire*.
 - b. Read announcements and other evidential matter in support of the actual program of re-emphasis.
13. Does the Company have a procedure for voluntarily reporting violations of federal procurement laws to appropriate governmental agencies?

Determine by inquiry of Company officials and/or by reading relevant documentation how the Company's procedures operate for determining whether violations of federal procurement laws are to be reported to appropriate governmental agencies and examine evidential matter to determine whether such procedures are being implemented.
14. Is implementation of the Code's provisions one of the standards by which all levels of supervision are expected to be measured in their performance?
 - a. Determine by inquiry of Company officials and/or by reading relevant documentation, such as position descriptions and personnel policies, whether performance evaluations are to consider supervisors' efforts in the implementation of the Code's provisions as a standard of measurement of their performance.
 - b. Obtain additional evidential matter to determine that supervisors are responsible for implementation of the Code's provisions.
15. Is there a program to monitor on a continuing basis adherence to the Code of conduct and compliance with federal procurement laws?
 - a. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company monitors, on

- a continuing basis, adherence to the Code and compliance with federal procurement laws.
- b. Obtain additional evidential matter, for example by reading internal audit reports, of the Company's monitoring of compliance with the Code and federal procurement laws.
16. Does the Company participate in the industry's "Best Practices Forum"?
- Examine evidence of the Company's participation in the "Best Practices Forum."
17. Are periodic reports on adherence to the principles made to the Company's board of directors or to its audit or other appropriate committee?
- Determine by inquiry of Company officials and/or by reading minutes of the board of directors or audit or other appropriate committee meetings or other relevant documentation whether Company officials have reported on adherence to the principles of business ethics and conduct.
18. Are the Company's independent public accountants or a similar independent organization required to comment to the board of directors or a committee thereof on the efficacy of the Company's internal procedures for implementing the Company's Code of conduct?
- Determine by inquiry of Company officials and/or by reading relevant documentation whether the Company's independent accountants or a similar independent organization are required to comment to the board of directors or a committee thereof on the efficacy of the Company's internal procedures for implementing the Company's Code.

Appendix B

.23 Illustrative Defense Contractor Assertions and Examination Reports

Defense Industry Questionnaire on Business Ethics and Conduct

Illustration 1: Unqualified Opinion

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct* for the period from _____ to _____.

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company* for the period from _____ to _____ are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____.

Examination Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct* for the period from _____ to _____, and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire*. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

In our opinion, the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct* for the period from _____ to _____ referred to above are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Illustration 2: Unqualified Opinion; Report Modified for Negative Responses

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct* for the period from _____ to _____.

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____* are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Attachments

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____.

(The responses could include an explanation of negative responses if the defense contractor so desired.)

Examination Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____*, and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire*. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

In our opinion, the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____* referred to above are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire. The negative responses to Questions _____ and _____ in the Questionnaire indicate that the Company did not have policies and programs in operation during the period with respect to those areas.

Illustration 3: Opinion Modified for Exception on Certain Response

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from _____ to _____*.

The affirmative responses in the accompanying Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____ are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____.

Examination Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____*, and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the Questionnaire. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's Code of Business Ethics and Conduct on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

In our opinion, except for the response to Question 10 as discussed in the following paragraph, the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____* referred to above are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

Management believes that an appropriate mechanism exists for informing employees of the results of the Company's follow-up into charges of violations of the Company's Code of Business Ethics and Conduct, and has accordingly answered Question 10 in the affirmative. That mechanism consists principally of distributing newspaper articles and press releases of violations of federal procurement laws that have been voluntarily reported to the appropriate governmental agencies. We do not believe that such a mechanism is sufficient, in as much as it does not provide follow-up information on violations reported by employees that are not deemed reportable to a governmental agency. Consequently, in our opinion, the affirmative response to Question 10 in the Questionnaire is not appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Illustration 4: Opinion Modified for Exception on Certain Response; Report also Modified for Negative Responses

Defense Contractor Assertion

Statement of Responses to the *Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____*.

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____* are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Attachments

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____.

(The responses could include an explanation of negative responses if the defense contractor so desired.)

Examination Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____*, and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire*. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

In our opinion, except for the response to Question 10 as discussed in the following paragraph, the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____* referred to above are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire. The negative responses to Questions _____ and _____ in the Questionnaire indicate that the Company did not have policies and programs in operation during the period with respect to those areas.

Management believes that an appropriate mechanism exists for informing employees of the results of the Company's follow-up into charges of violations of the Company's Code of Business Ethics and Conduct, and has accordingly answered Question 10 in the affirmative. That mechanism consists principally of distributing newspaper articles and press releases of violations of federal procurement laws that have been voluntarily reported to the appropriate governmental agencies. We do not believe that such a mechanism is sufficient, in as much as it does not provide follow-up information on violations reported by employees that are not deemed reportable to a governmental agency. Consequently, in our opinion, the affirmative response to Question 10 in the Questionnaire is not appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Illustration 5: Opinion Disclaimed on Certain Responses Because of Scope Restrictions Imposed by Client

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from _____ to _____*.

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____* are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____.

Examination Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____*, and the Questionnaire and responses attached thereto. Except as explained in the following paragraph, our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire*. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

We were not permitted to read relevant documents and files or interview appropriate employees to determine that the affirmative answers to Questions 8, 9, and 10 are appropriate. The nature of those questions precluded us from satisfying ourselves as to the appropriateness of those answers by means of other examination procedures.

In our opinion, the affirmative responses to Questions 1 through 7 and 11 through 18 in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____* referred to above are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire. Because of the matters discussed in the preceding paragraph, the scope of our work was not sufficient to express, and we do not express, an opinion on the appropriateness of the affirmative responses to Questions 8, 9, and 10 in the Questionnaire.

Appendix C

.24 Background

Defense Industry Questionnaire on Business Ethics and Conduct

The June 1986 final report to the President of the United States, *A Quest for Excellence*, by the President's Blue Ribbon Commission on Defense Management (the "Packard Commission") included as an appendix the *Defense Industry Initiatives on Business Ethics and Conduct (Initiatives)* written by leaders in the defense industry and signed by many of the country's major defense contractors. The *Initiatives*, which were endorsed by the Packard Commission, set forth six principles of business ethics and conduct, which signatories to the *Initiatives* are committed to adopt and implement.

The sixth principle of business ethics and conduct specifies that "Each company must have public accountability for its commitment to these principles." The section of the *Initiatives* on implementation contains the following discussion of the sixth principle:

The mechanism for public accountability will require each company to have its independent public accountants or similar independent organization complete and submit annually the attached questionnaire to an external independent body which will report the results for the industry as a whole and release the data simultaneously to the companies and the general public.

This annual review, which will be conducted for the next three years, is a critical element giving force to these principles and adding integrity to this defense industry initiative as a whole. Ethical accountability, as a good-faith process, should not be affirmed behind closed doors. The defense industry is confronted with a problem of public perception—a loss of confidence in its integrity—that must be addressed publicly if the results are to be both real and credible, to the government and public alike. It is in this spirit of public accountability that this initiative has been adopted and these principles have been established.

Appendix D to this Interpretation [paragraph .25] reproduces in full the *Initiatives*, including the *Questionnaire on Business Ethics and Conduct (Questionnaire)*.

Representatives of the signatories to the *Initiatives* have agreed that the defense contractor assertion illustrated in Appendix B and Appendix F [paragraphs .23 and .27], with the attachments thereto, is the appropriate vehicle for meeting the sixth principle referred to above. They also have agreed that each signatory should adopt and implement a code of business ethics and conduct that, in a self-contained document, addresses all of the required provisions of the six principles. In 1987, representatives of the signatories to the *Initiatives* created the External Independent Organization of the Defense Industry (EIODI) as the body to receive responses to the *Questionnaire*, report the results for the defense industry as a whole, and release the data to the companies and the public. The Auditing Standards Division of the American Institute of Certified Public Accountants, the EIODI, and representatives of the signatories to the *Initiatives* have agreed to a framework, which is embodied in this Interpretation, in which practitioners can accept engagements to attest to the answers to the *Questionnaire* and issue reports on the results of those engagements.

Appendix D

.25 Defense Industry Initiatives on Business Ethics and Conduct and Questionnaire on Business Ethics and Conduct *

Business Ethics and Conduct

The defense industry companies who sign this document already have, or commit to adopt and implement, a set of principles of business ethics and conduct that acknowledge and address their corporate responsibilities under federal procurement laws and to the public. Further, they accept the responsibility to create an environment in which compliance with federal procurement laws and free, open, and timely reporting of violations become the felt responsibility of every employee in the defense industry.

In addition to adopting and adhering to this set of six principles of business ethics and conduct, we will take the leadership in making the principles a standard for the entire defense industry.

I. Principles

1. Each company will have and adhere to a written code of business ethics and conduct.
2. The company's code establishes the high values expected of its employees and the standard by which they must judge their own conduct and that of their organization; each company will train its employees concerning their personal responsibilities under the code.
3. Each company will create a free and open atmosphere that allows and encourages employees to report violations of its code to the company without fear of retribution for such reporting.
4. Each company has the obligation to self-govern by monitoring compliance with federal procurement laws and adopting procedures for voluntary disclosure of violations of federal procurement laws and corrective actions taken.
5. Each company has a responsibility to each of the other companies in the industry to live by standards of conduct that preserve the integrity of the defense industry.
6. Each company must have public accountability for its commitment to these principles.

II. Implementation: Supporting Programs

While all companies pledge to abide by the six principles, each company agrees that it has implemented or will implement policies and programs to meet its management needs.

Principle 1: Written Code of Business Ethics and Conduct

A company's code of business ethics and conduct should embody the values that it and its employees hold most important; it is the highest expression of a corporation's culture. For a defense contractor, the code

* From *A Quest for Excellence*, appendix, final report by the President's Blue Ribbon Commission on Defense Management, June 1986.

represents the commitment of the company and its employees to work for its customers, shareholders, *and* the nation.

It is important, therefore, that a defense contractor's written code explicitly address that higher commitment. It must also include a statement of the standards that govern the conduct of all employees in their relationships to the company, as well as in their dealings with customers, suppliers, and consultants. The statement also must include an explanation of the consequences of violating those standards, and a clear assignment of responsibility to operating management and others for monitoring and enforcing the standards throughout the company.

Principle 2: Employees' Ethical Responsibilities

A company's code of business ethics and conduct should embody the basic values and culture of a company and should become a way of life, a form of honor system, for every employee. Only if the code is embodied in some form of honor system does it become more than mere words or abstract ideals. Adherence to the code becomes a responsibility of each employee both to the company and to fellow employees. Failure to live by the code, or to report infractions, erodes the trust essential to personal accountability and an effective corporate business ethics system.

Codes of business ethics and conduct are effective only if they are fully understood by every employee. Communications and training are critical to preparing employees to meet their ethical responsibilities. Companies can use a wide variety of methods to communicate their codes and policies and to educate their employees as to how to fulfill their obligations. Whatever methods are used—broad distribution of written codes, personnel orientation programs, group meetings, videotapes, and articles—it is critical that they ensure total coverage.

Principle 3: Corporate Responsibility to Employees

Every company must ensure that employees have the opportunity to fulfill their responsibility to preserve the integrity of the code and their honor system. Employees should be free to report suspected violations of the code to the company without fear of retribution for such reporting.

To encourage the surfacing of problems, normal management channels should be supplemented by a confidential reporting mechanism.

It is critical that companies create and maintain an environment of openness where disclosures are accepted and expected. Employees must believe that to raise a concern or report misconduct is expected, accepted, and protected behavior, not the exception. This removes any legitimate rationale for employees to delay reporting alleged violations or for former employees to allege past offenses by former employers or associates.

To receive and investigate employee allegations of violations of the corporate code of business ethics and conduct, defense contractors can use a contract review board, an ombudsman, a corporate ethics or compliance office or other similar mechanism.

In general, the companies accept the broadest responsibility to create an environment in which free, open and timely reporting of any suspected violations becomes the felt responsibility of every employee.

Principle 4: Corporate Responsibility to the Government

It is the responsibility of each company to aggressively self-govern and monitor adherence to its code and to federal procurement laws. Procedures will be established by each company for voluntarily reporting to appropriate

government authorities violations of federal procurement laws and corrective actions.

In the past, major importance has been placed on whether internal company monitoring has uncovered deficiencies before discovery by governmental audit. The process will be more effective if all monitoring efforts are viewed as mutually reinforcing and the measure of performance is a timely and constructive surfacing of issues.

Corporate and government audit and control mechanisms should be used to identify and correct problems. Government and industry share this responsibility and must work together cooperatively and constructively to ensure compliance with federal procurement laws and to clarify any ambiguities that exist.

Principle 5: Corporate Responsibility to the Defense Industry

Each company must understand that rigorous self-governance is the foundation of these principles of business ethics and conduct and of the public's perception of the integrity of the defense industry.

Since methods of accountability can be improved through shared experience and adaptation, companies will participate in an annual intercompany "Best Practices Forum" that will bring together operating and staff managers from across the industry to discuss ways to implement the industry's principles of accountability.

Each company's compliance with the principles will be reviewed by a Board of Directors committee comprised of outside directors.

Principle 6: Public Accountability

The mechanism for public accountability will require each company to have its independent public accountants or similar independent organization complete and submit annually the attached questionnaire to an external independent body which will report the results for the industry as a whole and release the data simultaneously to the companies and the general public.

This annual review, which will be conducted for the next three years, is a critical element giving force to these principles and adding integrity to this defense industry initiative as a whole. Ethical accountability, as a good-faith process, should not be affirmed behind closed doors. The defense industry is confronted with a problem of public perception—a loss of confidence in its integrity—that must be addressed publicly if the results are to be both real and credible, to the government and public alike. It is in this spirit of public accountability that this initiative has been adopted and these principles have been established.

Questionnaire

1. Does the company have a written code of business ethics and conduct?
2. Is the code distributed to all employees principally involved in defense work?
3. Are new employees provided any orientation to the code?
4. Does the code assign responsibility to operating management and others for compliance with the code?
5. Does the company conduct employee training programs regarding the code?
6. Does the code address standards that govern the conduct of employees in their dealings with suppliers, consultants and customers?

7. Is there a corporate review board, ombudsman, corporate compliance or ethics office or similar mechanism for employees to report suspected violations to someone other than their direct supervisor, if necessary?
8. Does the mechanism employed protect the confidentiality of employee reports?
9. Is there an appropriate mechanism to follow-up on reports of suspected violations to determine what occurred, who was responsible, and recommended corrective and other actions?
10. Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?
11. Is there an ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the code of conduct?
12. What are the specifics of such a program?
 - a. Written communication?
 - b. One-on-one communication?
 - c. Group meetings?
 - d. Visual aids?
 - e. Others?
13. Does the company have a procedure for voluntarily reporting violations of federal procurement laws to appropriate governmental agencies?
14. Is implementation of the code's provisions one of the standards by which all levels of supervision are expected to be measured in their performance?
15. Is there a program to monitor on a continuing basis adherence to the code of conduct and compliance with federal procurement laws?
16. Does the company participate in the industry's "Best Practices Forum"?
17. Are periodic reports on adherence to the principles made to the company's Board of Directors or to its audit or other appropriate committee?
18. Are the company's independent public accountants or a similar independent organization required to comment to the Board of Directors or a committee thereof on the efficacy of the company's internal procedures for implementing the company's code of conduct?

Appendix E

.26 Illustrative Procedures for Review of Answers to Questionnaire

Defense Industry Questionnaire on Business Ethics and Conduct

Before performing procedures, the practitioner should read the *Defense Industry Initiatives on Business Ethics and Conduct*.

1. Does the Company have a written Code of Business Ethics and Conduct?
Determine whether the Company has a written Code of Business Ethics and Conduct.
2. Is the Code distributed to all employees principally involved in defense work?
Determine by inquiry of Company officials and/or by reading relevant documentation how the Company distributes the Code to all employees principally involved in defense work.
3. Are new employees provided any orientation to the Code?
Determine by inquiry of Company officials and/or by reading relevant documentation how the Company provides an orientation to the Code to new employees.
4. Does the Code assign responsibility to operating management and others for compliance with the Code?
Read the Code to determine whether it includes (a) the assignment of responsibility for compliance with the Code to operating management and others, and (b) a statement of the standards that govern the conduct of all employees in their relationships to the Company.
5. Does the Company conduct employee training programs regarding the Code?
Determine by inquiry of Company officials and/or by reading relevant documentation how the Company conducts training programs regarding the Code.
6. Does the Code address standards that govern the conduct of employees in their dealings with suppliers, consultants and customers?
Read the Code to determine whether it addresses standards that govern the conduct of employees in their dealings with suppliers, consultants, and customers.
7. Is there a corporate review board, ombudsman, corporate compliance or ethics office or similar mechanism for employees to report suspected violations to someone other than their direct supervisor, if necessary?
Determine by inquiry of Company officials and/or by reading relevant documentation whether a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism exists for employees to report suspected violations.
8. Does the mechanism employed protect the confidentiality of employee reports?

- a. Determine by inquiry of members of the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism established by the Company whether they understand the need to protect the confidentiality of employee reports.
 - b. Determine by inquiry of Company officials and/or by reading relevant documentation how the procedures employed protect this confidentiality.
9. Is there an appropriate mechanism to follow-up on reports of suspected violations to determine what occurred, who was responsible, and recommended corrective and other actions?
Determine by inquiry of Company officials and/or by reading relevant documentation how the follow-up procedures established by the Company operate and whether an appropriate mechanism exists to follow-up on reports of suspected violations reported to a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism to determine what occurred, who was responsible, and recommended corrective and other action.
10. Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?
 - a. Determine by inquiry of Company officials and/or by reading relevant documentation whether an appropriate mechanism exists for letting employees know the result of any follow-up into their reported charges.
 - b. Determine by inquiry of members of the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism whether the results of the Company's follow-up of reported charges have been communicated to employees.
11. Is there an ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the Code of conduct?

and
12. What are the specifics of such a program?
 - A. Written communication?
 - B. One-on-one communication?
 - C. Group meetings?
 - D. Visual aids?
 - E. Others?Determine by inquiry of Company officials and/or by reading relevant documentation the extent of the Company's ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the Code. Note the specific means of communication and compare to the Company's response to Question 12 of the Questionnaire.
13. Does the Company have a procedure for voluntarily reporting violations of federal procurement laws to appropriate governmental agencies?

Determine by inquiry of Company officials and/or by reading relevant documentation how the Company's procedures operate for determining whether violations of federal procurement laws are to be reported to appropriate governmental agencies.

14. Is implementation of the Code's provisions one of the standards by which all levels of supervision are expected to be measured in their performance?

Determine by inquiry of Company officials and/or by reading relevant documentation, such as position descriptions and personnel policies, whether performance evaluations are to consider supervisors' efforts in the implementation of the Code's provisions as a standard of measurement of their performance.

15. Is there a program to monitor on a continuing basis adherence to the Code of Conduct and compliance with federal procurement laws?

Determine by inquiry of Company officials and/or by reading relevant documentation how the Company monitors, on a continuing basis, adherence to the Code and compliance with federal procurement laws.

16. Does the Company participate in the industry's "Best Practices Forum"?

Determine by inquiry of Company officials and/or by reading relevant documentation whether the Company participated in the "Best Practices Forum."

17. Are periodic reports on adherence to the principles made to the Company's Board of Directors or to its audit or other appropriate committee?

Determine by inquiry of Company officials and/or by reading minutes of the Board of Directors or audit or other appropriate committee meetings or other relevant documentation whether Company officials have reported on adherence to the principles of business ethics and conduct.

18. Are the Company's independent public accountants or a similar independent organization required to comment to the Board of Directors or a committee thereof on the efficacy of the Company's internal procedures for implementing the Company's Code of Conduct?

Determine by inquiry of Company officials and/or by reading relevant documentation whether the Company's independent accountants or a similar independent organization are required to comment to the Board of Directors or a committee thereof on the efficacy of the Company's internal procedures for implementing the Company's Code.

Appendix F

.27 Illustrative Defense Contractor Assertion and Review Report

Defense Industry Questionnaire on Business Ethics and Conduct

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from _____ to _____*.

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____* are based on policies and programs in operation during that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____.

Review Report

To the Board of Directors of the XYZ Company

We have reviewed the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____*, and the Questionnaire and responses attached thereto. Our review was made in accordance with standards established by the American Institute of Certified Public Accountants. Our review was designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire*. Our review was not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____*. Accordingly, we do not express such an opinion.

Based on our review, nothing came to our attention that caused us to believe that the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____* referred to above are not appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

[Issue Date: August, 1987.]

[The next page is 1571.]

AU Section 2012

Interpretation of Attestation Standards: Responding to Requests for Reports on Matters Relating to Solvency

The staff of the Auditing Standards Division has been authorized to issue interpretations to provide timely guidance on the application of pronouncements of the Auditing Standards Board. Interpretations are reviewed by the members of that Board. An interpretation is not as authoritative as a pronouncement of the Auditing Standards Board, but members should be aware that they may have to justify a departure from an interpretation if the quality of their work is questioned.

.01 Question—Lenders, as a requisite to the closing of certain secured financings in connection with leveraged buyouts (LBOs), recapitalizations and certain other financial transactions, have sometimes requested written assurance from an accountant regarding the prospective borrower's solvency and related matters.¹ The lender is concerned that such financings not be considered to include a fraudulent conveyance or transfer under the Federal Bankruptcy Code² or the relevant state fraudulent conveyance or transfer statute.³ If the financing is subsequently determined to have included a fraudulent

¹ While this interpretation describes requests from secured lenders and summarizes the potential effects of fraudulent conveyance or transfer laws upon such lenders, the interpretation is not limited to requests from lenders. All requests for assurance on matters relating to solvency are governed by this interpretation.

² Section 548 of the Federal Bankruptcy Code defines fraudulent transfers and obligations as follows:

"The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

"(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer occurred or such obligation was incurred, indebted; or

"(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

"(2)(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

"(2)(B)(ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

"(2)(B)(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured." (Bankruptcy Law Reporter, 3 vols. [Chicago: Commerce Clearing House, 1986], vol. 1, 1339).

³ State fraudulent conveyance or transfer statutes such as the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act reflect substantially similar provisions. These state laws may be employed absent a declaration of bankruptcy or by a bankruptcy trustee under section 544(1) of the Federal Bankruptcy Code. While the statute of limitations varies from state to state, in some states financing transactions may be vulnerable to challenge for up to six years from closing.

conveyance or transfer, repayment obligations and security interests may be set aside or subordinated to the claims of other creditors.

.02 May an accountant provide assurance concerning “matters relating to solvency” as hereinafter defined?

.03 Interpretation—No. For reasons set forth below, an accountant should not provide any form of assurance, through examination, review or agreed-upon procedures engagements, that an entity

- Is not insolvent at the time the debt is incurred or would not be rendered insolvent thereby.
- Does not have unreasonably small capital.
- Has the ability to pay its debts as they mature.

In the context of particular transactions other terms are sometimes used or defined by the parties as equivalents of or substitutes for the terms listed above (e.g., fair salable value of assets exceeds liabilities). These terms, and those matters listed above, are hereinafter referred to as “matters relating to solvency.” The prohibition extends to providing assurance concerning all such terms.

.04 The assertions on which an accountant can provide assurance are limited by the attestation standards included in the Statement on Standards for Attestation Engagements, *Attestation Standards* [section 2010]. The third general attestation standard states that the practitioner shall perform the engagement only if he or she has reason to believe that the following conditions exist:

- The assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them.
- The assertion is capable of reasonably consistent estimation or measurement using such criteria.

In addition, the second general attestation standard states that the engagement shall be performed by a practitioner or practitioners having adequate knowledge in the subject matter of the assertion.

.05 The matters relating to solvency mentioned in paragraph .03 above are subject to legal interpretation under, and varying legal definition in, the Federal Bankruptcy Code and various state fraudulent conveyance and transfer statutes. Because these matters are not clearly defined in an accounting sense, and are therefore subject to varying interpretations, they do not provide the accountant with the reasonable criteria required to evaluate the assertion under the third general attestation standard. In addition, lenders are concerned with legal issues on matters relating to solvency and the accountant is generally unable to evaluate or provide assurance on these matters of legal interpretation. Therefore, accountants are precluded from giving any form of assurance on matters relating to solvency or any financial presentation of matters relating to solvency.

.06 The rescinded auditing interpretation titled “Reporting on Solvency,” issued in December 1984 (before the attestation standards [section 2010], which were effective in September 1986), indicated that accountants’ solvency letters should contain definitions for the accountant to use in providing negative assurance. While lenders have defined matters relating to solvency in the context of a particular engagement, experience has shown that use of the

lender's definitions by the accountant in a solvency letter could be misunderstood as an assurance by the accountant that a particular financing does not include a fraudulent conveyance or transfer under either federal or state law. Further, those who are not aware that the matters relating to solvency have been specifically defined for the engagement may, as a result of being informed that an accountant has issued a report on matters relating to solvency, infer unwarranted assurance therefrom.

.07 Under existing AICPA standards, the accountant may provide a client with various professional services that may be useful to the client in connection with a financing. These services include

- Audit of historical financial statements.
- Review of historical financial information (a review in accordance with section 722, *Review of Interim Financial Information*, of interim financial information or in accordance with Statement on Standards for Accounting and Review Services No. 1, *Compilation and Review of Financial Statements*).
- Examination or review of pro forma financial information.
- Examination or compilation of prospective financial information (section 2100, *Financial Forecasts and Projections*).

.08 In addition, under existing AICPA standards (section 622, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*, section 2010, and section 2100), the accountant can provide the client and lender with an agreed-upon procedures report. In such an engagement, a client and lender may request that specified procedures be applied to various financial presentations, such as historical financial information, pro forma financial information and prospective financial information, which can be useful to a client or lender in connection with a financing.

.09 The accountant should be aware that certain of the services described in paragraph .07 require that the accountant have an appropriate level of knowledge of the entity's accounting and financial reporting practices and its internal control structure. This has ordinarily been obtained by the accountant auditing historical financial statements of the entity for the most recent annual period or by otherwise obtaining an equivalent knowledge base. When considering acceptance of an engagement relating to a financing, the accountant should consider whether he or she can perform these services without an equivalent knowledge base.

.10 A report on agreed-upon procedures should not provide any assurances on matters relating to solvency or any financial presentation of matters relating to solvency (e.g., fair salable value of assets less liabilities or fair salable value of assets less liabilities, contingent liabilities and other commitments). An accountant's report on the results of applying agreed-upon procedures should

- State that the service has been requested in connection with a financing (no reference should be made to any solvency provisions in the financing agreement).
- State that the sufficiency of the procedures is the sole responsibility of the client and lender and disclaim responsibility for the sufficiency of those procedures.
- State that no representations are provided regarding questions of legal interpretation.

- State that no assurance is provided concerning the borrower's (1) solvency, (2) adequacy of capital or (3) ability to pay its debts.
- State that the procedures should not be taken to supplant any additional inquiries and procedures that the lender should undertake in its consideration of the proposed financing.
- Where applicable, state that an audit of recent historical financial statements has previously been performed and that no audit of any historical financial statements for a subsequent period has been performed. In addition, if other services have been performed pursuant to paragraph .07, they may be referred to.
- Describe the procedures applied (as applicable) to the historical financial information, prospective financial information or pro forma financial information and the accountant's findings.
- Where applicable, state that the procedures were less in scope than (1) an audit in accordance with generally accepted auditing standards; (2) an examination of pro forma financial information, the objective of which is the expression of an opinion on that information; (3) an examination of prospective financial statements in accordance with standards established by the AICPA, and include an appropriate disclaimer of opinion.
- If procedures have been applied to prospective financial information, state that there will usually be differences between the prospective financial information and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.
- State that had the accountant performed additional procedures or performed an audit or examination, additional matters might have come to his or her attention that would have been reported.
- State the limitations on the use of the report because it is intended solely for the use of specified parties.
- State that the accountant has no responsibility to update the report.

.11 The report ordinarily is dated at or shortly before the closing date. The financing agreement ordinarily specifies the date, often referred to as the cutoff date, to which the report is to relate (for example, a date three business days before the date of the report). The report should state that the inquiries and other procedures carried out in connection with the report did not cover the period from the cutoff date to the date of the report.

.12 The accountant might consider furnishing the client with a draft of the agreed-upon procedures report. The draft report should deal with all matters expected to be covered in the terms expected to be used in the final report. The draft report should be identified as a draft in order to avoid giving the impression that the procedures described therein have been performed. This practice of furnishing a draft report at an early point permits the accountant to make clear to the client and lender what they may expect the accountant to furnish and gives them an opportunity to change the financing agreement or the agreed-upon procedures if they so desire.

.13 The following is an example of an agreed-upon procedures report issued in response to a request by a client and lender in connection with the financing of an LBO transaction in which agreed-upon procedures have been

applied to unaudited historical financial information, unaudited pro forma financial information and a forecast.

.14 Illustrative Agreed-Upon Procedures Report (Leveraged Buyout Transaction)

March 24, 19X2

XYZ Bank and ABC Corporation:

This report is furnished at the request of XYZ Bank and ABC Corporation pursuant to the Credit Agreement dated as of March 24, 19X2 (the "Credit Agreement"), between ABC Corporation (the borrower) and XYZ Bank (the lender) in connection with the financing transaction set forth therein.

The sufficiency of the agreed-upon procedures we have been requested to perform, as set forth in subsequent paragraphs of this report, is the sole responsibility of the borrower and lender. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purposes for which this report has been requested or for any other purpose. Further, we make no representations regarding questions of legal interpretation, nor do we provide any assurance as to any matters relating to the borrower's solvency, adequacy of capital or ability to pay its debts. The agreed-upon procedures described below should not be taken to supplant any additional inquiries and procedures that the lender should undertake in its consideration of the proposed financing transaction contemplated by the Credit Agreement.

We have previously audited the consolidated balance sheet of the borrower as of December 31, 19X1, and the related consolidated statements of income, stockholders' equity and cash flow for the year then ended, and have rendered our unqualified report thereon dated February 27, 19X2. We have not audited any financial statements of the borrower as of any date or for any period subsequent to December 31, 19X1.

As requested, we have performed the following agreed-upon procedures as of and for the periods set forth below (our procedures did not extend to the period from March 21, 19X2, to March 24, 19X2, inclusive):

1. We have read the minutes of the 19X2 meetings of the stockholders and board of directors of the borrower as set forth in the minute books at March 20, 19X2, officials of the borrower having advised us that the minutes of all such meetings through that date were set forth therein.

2. We have read the accompanying unaudited consolidated financial statements of the borrower as of February 28, 19X2, and for the two-month period then ended, officials of the borrower having advised us that no financial statements as of any date or for any period subsequent to February 28, 19X2, were available.

3. We have made inquiries of certain officials of the borrower who have responsibility for financial and accounting matters regarding whether

- a. The unaudited consolidated financial statements referred to above are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the December 31, 19X1, audited consolidated financial statements.

- b. At March 20, 19X2, there was any decrease in consolidated net assets or consolidated net current assets as compared with the amounts shown in the February 28, 19X2, unaudited consolidated balance sheet.

Based on the results of the procedures described in steps 1 through 3, above, nothing came to our attention that caused us to believe that the February 28, 19X2, financial statements are not in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the December 31, 19X1, audited financial statements or that, at March 20, 19X2, there was any decrease in consolidated net assets or consolidated net current assets as compared with the amounts shown on the February 28, 19X2, unaudited consolidated balance sheet.

4. With respect to the accompanying unaudited pro forma consolidated balance sheet as of February 28, 19X2,¹ which has been prepared on the basis set forth in the notes and assumptions thereto, we have

a. Read the unaudited pro forma consolidated balance sheet and supporting notes and assumptions.

b. Made inquiries of certain officials of the borrower who have responsibility for financial and accounting matters as to whether all adjustments necessary to present the unaudited pro forma consolidated balance sheet in accordance with the basis set forth in the notes thereto have been made.

c. Discussed with certain officials of the borrower their assumptions regarding the effects of the transaction set forth in the notes to the unaudited pro forma consolidated balance sheet.

d. Compared the amounts shown in the unaudited consolidated balance sheet of the borrower at February 28, 19X2, and in the unaudited pro forma consolidated balance sheet to the corresponding amounts shown on worksheets prepared by the borrower and found them to be in agreement; tested the mathematical accuracy of such worksheets.

Based on the results of the procedures described in 4a-d, above, no matters came to our attention that caused us to believe that the unaudited pro forma consolidated balance sheet does not reflect the proper application of the pro forma adjustments to the historical unaudited consolidated balance sheet.

5. With respect to the accompanying forecasted statement of consolidated cash flows for the three years ending December 31, 19X4, (the forecast), prepared by the borrower, we have

a. Read the forecast for compliance in regard to format with the preparation guidelines established by the American Institute of Certified Public Accountants (AICPA) for presentation of a forecast.

b. Tested the mathematical accuracy of the forecast.

Based on the results of the procedures referred to in steps 5a-b, no matters came to our attention to cause us to believe that the format of the forecast should be modified or that the forecast is mathematically inaccurate.

Because the foregoing procedures in steps 1-4 do not constitute an audit made in accordance with generally accepted auditing standards or an examination made in accordance with attestation standards established by the AICPA, we do not express an opinion on the February 28, 19X2, unaudited historical consolidated financial statements or unaudited pro forma consolidated balance sheet. Because the procedures described in steps 1 and 5a-b above do not constitute an examination of prospective financial statements in accordance with standards established by the AICPA, we do not express an opinion on whether the forecast referred to above is presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions

¹ For example, this presentation might reflect a *business combination* accounted for as a purchase under Accounting Principles Board Opinion No. 16, *Business Combinations*.

provide a reasonable basis for the presentation. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.

Had we performed additional procedures or had we audited the borrower's February 28, 19X2, consolidated financial statements in accordance with generally accepted auditing standards or had we examined the borrower's unaudited pro forma consolidated balance sheet or the forecast in accordance with standards established by the AICPA, other matters might have come to our attention that would have been reported to you.

This report is intended solely for use by the borrower and the lender in connection with the loan contemplated under the Credit Agreement and is not to be otherwise used, circulated, quoted or referred to by the borrower or the lender and should not be used by any party who did not participate in determining the foregoing procedures.

We have no responsibility to update this report for events and circumstances occurring after March 20, 19X2.

[Issue Date: May, 1988.]

AU Section 2100

STATEMENT ON STANDARDS FOR ACCOUNTANTS' SERVICES ON PROSPECTIVE FINANCIAL INFORMATION

This Statement is issued by the Auditing Standards Board under the authority granted it by Council of the Institute to interpret rule 201, General Standards, of the Institute's Code of Professional Ethics. Members should be prepared to justify departures from this Statement.

... financial forecasts and projections ...

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AU Section 2100

Financial Forecasts and Projections

Effective for
engagements in which
the date of
completion of the
accountant's services
on prospective
financial statements is
September 30, 1986,
or later, unless
otherwise indicated

.01 This section sets forth standards and provides guidance to accountants concerning performance and reporting for engagements to examine (paragraphs .27 through .48), compile (paragraphs .10 through .26), or apply agreed-upon procedures to (paragraphs .49 through .57) prospective financial statements.¹ This section is not applicable to presentations that do not meet the minimum presentation guidelines in Appendix A of this section. Such partial presentations are not deemed to be "prospective financial statements."

.02 Whenever an accountant (a) submits, to his client or others, prospective financial statements that he has assembled, or assisted in assembling, that are, or reasonably might be, expected to be used by another (third) party ² or (b) reports on prospective financial statements that are, or reasonably might be, expected to be used by another (third) party, he should perform one of the engagements described in the preceding paragraph. In deciding whether the prospective financial statements are, or reasonably might be, expected to be used by a third party, the accountant may rely on either the written or oral representation of the responsible party, unless information comes to his attention that contradicts the responsible party's representation. If such third party use of the prospective financial statements is not reasonably expected, the provisions of this section are not applicable unless the accountant has been engaged to examine, compile, or apply agreed-upon procedures to the prospective financial statements.

.03 This section does not provide standards or procedures for engagements involving prospective financial statements used solely in connection with litigation support services, although it provides helpful guidance for many

¹ The accountant should refer to rule 201(e) [ET section 201.01] of the AICPA Code of Professional Ethics and the related interpretation 201-2 [ET section 201.03], because this rule and interpretation are applicable to all engagements a member performs involving prospective financial information, including those engagements that are not covered by the provisions of this section.

² However, paragraph .58 permits an exception to this for certain types of budgets.

aspects of such engagements and may be referred to as useful guidance in such engagements. *Litigation support services* are engagements involving pending or potential formal legal proceedings before a "trier of fact" in connection with the resolution of a dispute between two or more parties, for example, in circumstances where an accountant acts as an expert witness. This exception is provided because, among other things, the accountant's work in such proceedings is ordinarily subject to detailed analysis and challenge by each party to the dispute. This exception does not apply, however, if the prospective financial statements are for use by third parties who, under the rules of the proceedings, do not have the opportunity for such analysis and challenge. For example, creditors may not have such opportunities when prospective financial statements are submitted to them to secure their agreement to a plan of reorganization.

.04 In reporting on prospective financial statements the accountant may be called on to assist the responsible party in identifying assumptions, gathering information, or assembling the statements.³ The responsible party is nonetheless responsible for the preparation and presentation of the prospective financial statements because the prospective financial statements are dependent on the actions, plans, and assumptions of the responsible party, and only it can take responsibility for the assumptions. Accordingly, the accountant's engagement should not be characterized in his report or in the document containing his report as including "preparation" of the prospective financial statements. An accountant may be engaged to prepare a financial analysis of a potential project where the engagement includes obtaining the information, making appropriate assumptions, and assembling the presentation. Such an analysis is not, and should not be characterized as, a forecast or projection and would not be appropriate for general use. However, if the responsible party reviewed and adopted the assumptions and presentation, or based its assumptions and presentation on the analysis, the accountant could perform one of the engagements described in this section and issue a report appropriate for general use.

.05 The concept of materiality affects the application of this section to prospective financial statements as materiality affects the application of generally accepted auditing standards to historical financial statements. Materiality is a concept that is judged in light of the expected range of reasonableness of the information; therefore, users should not expect prospective information (information about events that have not yet occurred) to be as precise as historical information.

³ Some of these services may not be appropriate if the accountant is to be named as the person reporting on an examination in a filing with the Securities and Exchange Commission (SEC). SEC Release Nos. 33-5992 and 34-15305, "Disclosure of Projections of Future Economic Performance," state that for prospective financial statements filed with the commission, "a person should not be named as an outside reviewer if he actively assisted in the preparation of the projection."

Definitions

.06 For the purposes of this section the following definitions apply.

Prospective financial statements. Either financial forecasts or financial projections including the summaries of significant assumptions and accounting policies. Although prospective financial statements may cover a period that has partially expired, statements for periods that have completely expired are not considered to be prospective financial statements. Pro forma financial statements⁴ and partial presentations⁵ are not considered to be prospective financial statements.

Financial forecast. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and changes in financial position. A financial forecast is based on the responsible party's assumptions reflecting conditions it expects to exist and the course of action it expects to take. A financial forecast may be expressed in specific monetary amounts as a single point estimate of forecasted results or as a range, where the responsible party selects key assumptions to form a range within which it reasonably expects, to the best of its knowledge and belief, the item or items subject to the assumptions to actually fall. When a forecast contains a range, the range is not selected in a biased or misleading manner, for example, a range in which one end is significantly less expected than the other. Minimum presentation guidelines for prospective financial statements are set forth in Appendix A of this section.

Financial projection. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and changes in financial position. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question such as "What would happen if . . . ?" A financial projection is based on the responsible party's assumptions reflecting conditions it expects would exist and the course of action it expects would be taken, given one or more hypothetical assumptions. A projection, like a forecast, may contain a range. Minimum presentation guidelines for prospective financial statements are set forth in Appendix A of this section.

Entity. Any unit, existing or to be formed, for which financial statements could be prepared in accordance with generally accepted accounting

⁴ "Pro forma" financial presentations are designed to demonstrate the effect of a future or hypothetical transaction by showing how it might have affected the historical financial statements if it had been consummated during the period covered by those statements. Although the transactions in question are prospective, this section does not apply to such presentations because they are essentially historical financial statements and do not purport to be prospective financial statements.

⁵ Partial presentations are presentations that do not meet the minimum presentation guidelines in Appendix A of this section.

principles or another comprehensive basis of accounting.⁶ For example, an entity can be an individual, partnership, corporation, trust, estate, association, or governmental unit.

Hypothetical assumption. An assumption used in a financial projection to present a condition or course of action that is not necessarily expected to occur, but is consistent with the purpose of the projection.

Responsible party. The person or persons who are responsible for the assumptions underlying the prospective financial statements. The responsible party usually is management, but it can be persons outside of the entity who do not currently have the authority to direct operations (for example, a party considering acquiring the entity).

Assembly. The manual or computer processing of mathematical or other clerical functions related to the presentation of the prospective financial statements. Assembly does not refer to the mere reproduction and collation of such statements or to the responsible party's use of the accountant's computer processing hardware or software.

Key factors. The significant matters on which an entity's future results are expected to depend. Such factors are basic to the entity's operations and thus encompass matters that affect, among other things, the entity's sales, production, service, and financing activities. Key factors serve as a foundation for prospective financial statements and are the bases for the assumptions.

Uses of Prospective Financial Statements

.07 Prospective financial statements are for either "general use" or "limited use." "General use" of prospective financial statements refers to use of the statements by persons with whom the responsible party is not negotiating directly, for example, in an offering statement of an entity's debt or equity interests. Because recipients of prospective financial statements distributed for general use are unable to ask the responsible party directly about the presentation, the presentation most useful to them is one that portrays, to the best of the responsible party's knowledge and belief, the expected results. Thus, only a financial forecast is appropriate for general use.

.08 "Limited use" of prospective financial statements refers to use of prospective financial statements by the responsible party alone or by the responsible party and third parties with whom the responsible party is negotiating directly. Examples include use in negotiations for a bank loan, submission to a regulatory agency, and use solely within the entity. Third-party recipients of prospective financial statements intended for limited use can ask questions of the responsible party and negotiate terms directly with it. Any type of prospective financial statements that would be useful in the circumstances would normally be appropriate for limited use. Thus, the presentation may be a financial forecast or a financial projection.

⁶ Section 621, *Special Reports*, discusses comprehensive bases of accounting other than generally accepted accounting principles.

.09 Because a financial projection is not appropriate for general use, an accountant should not consent to the use of his name in conjunction with a financial projection that he believes will be distributed to those who will not be negotiating directly with the responsible party, for example, in an offering statement of an entity's debt or equity interests, unless the projection is used to supplement a financial forecast.

Compilation of Prospective Financial Statements

.10 A compilation of prospective financial statements is a professional service that involves—

- a. Assembling, to the extent necessary, the prospective financial statements based on the responsible party's assumptions.
- b. Performing the required compilation procedures,⁷ including reading the prospective financial statements with their summaries of significant assumptions and accounting policies, and considering whether they appear to be (i) presented in conformity with AICPA presentation guidelines⁸ and (ii) not obviously inappropriate.
- c. Issuing a compilation report.

.11 A compilation is not intended to provide assurance on the prospective financial statements or the assumptions underlying such statements. Because of the limited nature of the accountant's procedures, a compilation does not provide assurance that the accountant will become aware of significant matters that might be disclosed by more extensive procedures, for example, those performed in an examination of prospective financial statements.

.12 The summary of significant assumptions is essential to the reader's understanding of prospective financial statements. Accordingly, the accountant should not compile prospective financial statements that exclude disclosure of the summary of significant assumptions. Also, the accountant should not compile a financial projection that excludes (a) an identification of the hypothetical assumptions or (b) a description of the limitations on the usefulness of the presentation.

.13 The following standards apply to a compilation of prospective financial statements and to the resulting report:

- a. The compilation should be performed by a person or persons having adequate technical training and proficiency to compile prospective financial statements.
- b. Due professional care should be exercised in the performance of the compilation and the preparation of the report.
- c. The work should be adequately planned, and assistants, if any, should be properly supervised.
- d. Applicable compilation procedures should be performed as a basis for reporting on the compiled prospective financial statements. (See Appendix B for the procedures to be performed.)

⁷ See Appendix B, paragraph 5, for the required procedures.

⁸ AICPA presentation guidelines are detailed in the *AICPA Guide for Prospective Financial Statements*.

- e. The report based on the accountant's compilation of prospective financial statements should conform to the applicable guidance in paragraphs .16 through .26 of this section.

.14 The accountant should consider, after applying the procedures specified in Appendix B, whether representations or other information he has received appear to be obviously inappropriate, incomplete, or otherwise misleading, and if so, the accountant should attempt to obtain additional or revised information. If he does not receive such information, the accountant should ordinarily withdraw from the compilation engagement.⁹ (Note that the omission of disclosures, other than those relating to significant assumptions, would not require the accountant to withdraw, see paragraph .24.)

Working Papers

.15 Although it is not possible to specify the form or content of the working papers that an accountant should prepare in connection with a compilation of prospective financial statements because of the different circumstances of individual engagements, the accountant's working papers ordinarily should indicate that—

- a. The work was adequately planned and supervised.
- b. The required compilation procedures were performed as a basis for the compilation report.

Reports on Compiled Prospective Financial Statements

.16 The accountant's standard report on a compilation of prospective financial statements should include—

- a. An identification of the prospective financial statements presented by the responsible party.
- b. A statement that the accountant has compiled the prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants.
- c. A statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the prospective financial statements or the assumptions.
- d. A caveat that the prospective results may not be achieved.
- e. A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

.17 The following is the form of the accountant's standard report on the compilation of a forecast that does not contain a range.¹⁰

⁹ The accountant need not withdraw from the engagement if the effect of such information on the prospective financial statement does not appear to be material.

¹⁰ The forms of reports provided in this section are appropriate whether the presentation is based on generally accepted accounting principles or on another comprehensive basis of accounting.

We have compiled the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants.¹¹

A compilation is limited to presenting in the form of a forecast information that is the representation of management¹² and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.18 When the presentation is a projection, the accountant's report should include a separate paragraph that describes the limitations on the usefulness of the presentation. The following is the form of the accountant's standard report on a compilation of a projection that does not contain a range.

We have compiled the accompanying projected balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants.¹³

The accompanying projection and this report were prepared for [*state special purpose, for example, "the DEF National Bank for the purpose of negotiating a loan to expand XYZ Company's plant,"*] and should not be used for any other purpose.

A compilation is limited to presenting in the form of a projection information that is the representation of management and does not include evaluation of the support for the assumptions underlying the projection. We have not examined the projection and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, even if [*describe hypothetical assumption, for example, "the loan is granted and the plant is expanded,"*] there will usually be differences between the projected and actual results, because events and circumstances

¹¹ When the presentation is summarized as discussed in Appendix A of this section, this sentence might read "We have compiled the accompanying summarized forecast of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants."

¹² When the responsible party is other than management, the references to management in the standard reports provided in this section should be changed to refer to the party who assumes responsibility for the assumptions.

¹³ When the presentation is summarized as discussed in Appendix A of this section, this sentence might read "We have compiled the accompanying summarized projection of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants."

frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.19 When the prospective financial statements contain a range, the accountant's standard report should also include a separate paragraph that states that the responsible party has elected to portray the expected results of one or more assumptions as a range. The following is an example of the separate paragraph to be added to the accountant's report when he compiles prospective financial statements, in this case a forecast, that contain a range.

As described in the summary of significant assumptions, management of XYZ Company has elected to portray forecasted *[describe financial statement element or elements for which the expected results of one or more assumptions fall within a range, and identify the assumptions expected to fall within a range, for example, "revenue at the amounts of \$X,XXX and \$Y,YYY, which is predicated upon occupancy rates of XX percent and YY percent of available apartments,"]* rather than as a single point estimate. Accordingly, the accompanying forecast presents forecasted financial position, results of operations, and changes in financial position *[describe one or more assumptions expected to fall within a range, for example, "at such occupancy rates."]* However, there is no assurance that the actual results will fall within the range of *[describe one or more assumptions expected to fall within a range, for example, "occupancy rates"]* presented.

.20 The date of completion of the accountant's compilation procedures should be used as the date of the report.

.21 An accountant may compile prospective financial statements for an entity with respect to which he is not independent.¹⁴ In such circumstances, the accountant should specifically disclose his lack of independence; however, the reason for the lack of independence should not be described. When the accountant is not independent, he may give the standard compilation report but should include the following sentence after the last paragraph.

We are not independent with respect to XYZ Company.

.22 Prospective financial statements may be included in a document that also contains historical financial statements and the accountant's report thereon.¹⁵ In addition, the historical financial statements that appear in the document may be summarized and presented with the prospective financial statements for comparative purposes.¹⁶ An example of the reference to the

¹⁴ In making a judgment about whether he is independent, the accountant should be guided by the AICPA Code of Professional Ethics. Also, see the auditing interpretation "Applicability of Guidance on Reporting When Not Independent" (section 9504.19—.22).

¹⁵ The accountant's responsibility with respect to those historical financial statements upon which he is not engaged to perform a professional service is described in section 504, *Association With Financial Statements*, in the case of public entities, and Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements*, paragraphs 5 through 7 [AR section 100.05—.07], in the case of nonpublic entities.

¹⁶ Section 552, *Reporting on Condensed Financial Statements and Selected Financial Data*, discusses the accountant's report where summarized financial statements are derived from audited statements that are not included in the same document.

accountant's report on the historical financial statements when he examined, reviewed, or compiled those statements is presented below.

(concluding sentence of last paragraph)

The historical financial statements for the year ended December 31, 19XX, (from which the historical data are derived) and our report thereon are set forth on pages xx-xx of this document.

.23 In some circumstances, an accountant may wish to expand his report to emphasize a matter regarding the prospective financial statements. Such information may be presented in a separate paragraph of the accountant's report. However, the accountant should exercise care that emphasizing such a matter does not give the impression that he is expressing assurance or expanding the degree of responsibility he is taking with respect to such information.¹⁷ For example, the accountant should not include statements in his compilation report about the mathematical accuracy of the statements or their conformity with presentation guidelines.

Modifications of the Standard Compilation Report

.24 An entity may request an accountant to compile prospective financial statements that contain presentation deficiencies or omit disclosures other than those relating to significant assumptions. The accountant may compile such prospective financial statements provided the deficiency or omission is clearly indicated in his report and is not, to his knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such statements.

.25 Notwithstanding the above, if the compiled prospective financial statements are presented on a comprehensive basis of accounting other than generally accepted accounting principles and do not include disclosure of the basis of accounting used, the basis should be disclosed in the accountant's report.

.26 The following is an example of a paragraph that should be added to a report on compiled prospective financial statements, in this case a financial forecast, in which the summary of significant accounting policies has been omitted.

Management has elected to omit the summary of significant accounting policies required by the guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants. If the omitted disclosures were included in the forecast, they might influence the user's conclusions about the Company's financial position, results of operations, and changes in financial position for the forecast period. Accordingly, this forecast is not designed for those who are not informed about such matters.

¹⁷ However, the accountant may provide assurance on tax matters in order to comply with the requirements of regulations governing practice before the Internal Revenue Service contained in 31 C.F.R. pt. 10 (Treasury Department Circular No. 230.)

Examination of Prospective Financial Statements

.27 An examination of prospective financial statements is a professional service that involves—

- a. Evaluating the preparation of the prospective financial statements.
- b. Evaluating the support underlying the assumptions.
- c. Evaluating the presentation of the prospective financial statements for conformity with AICPA presentation guidelines.¹⁸
- d. Issuing an examination report.

.28 As a result of his examination, the accountant has a basis for reporting on whether, in his opinion—

- a. The prospective financial statements are presented in conformity with AICPA guidelines.
- b. The assumptions provide a reasonable basis for the responsible party's forecast, or whether the assumptions provide a reasonable basis for the responsible party's projection given the hypothetical assumptions.

.29 The accountant should be independent; have adequate technical training and proficiency to examine prospective financial statements; adequately plan the engagement and supervise the work of assistants, if any; and obtain sufficient evidence to provide a reasonable basis for his examination report. (See Appendix C of this section for standards concerning such technical training and proficiency, planning the examination engagement, and the types of procedures an accountant should perform to obtain sufficient evidence for his examination report.)

Working Papers

.30 The accountant's working papers in connection with his examination of prospective financial statements should be appropriate to the circumstances and the accountant's needs on the engagement to which they apply. Although the quantity, type, and content of working papers vary with the circumstances, they ordinarily should indicate that—

- a. The work was adequately planned and supervised.
- b. The process by which the entity develops its prospective financial statements was considered in determining the scope of the examination.
- c. Sufficient evidence was obtained to provide a reasonable basis for the accountant's report.

Reports on Examined Prospective Financial Statements

.31 The accountant's standard report on an examination of prospective financial statements should include—

- a. An identification of the prospective financial statements presented.

¹⁸ AICPA presentation guidelines are detailed in the *AICPA Guide for Prospective Financial Statements*.

- b. A statement that the examination of the prospective financial statements was made in accordance with AICPA standards and a brief description of the nature of such an examination.
- c. The accountant's opinion that the prospective financial statements are presented in conformity with AICPA presentation guidelines¹⁹ and that the underlying assumptions provide a reasonable basis for the forecast or a reasonable basis for the projection given the hypothetical assumptions.
- d. A caveat that the prospective results may not be achieved.
- e. A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

.32 The following is the form of the accountant's standard report on an examination of a forecast that does not contain a range.

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending.²⁰ Our examination was made in accordance with standards for an examination of a forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.

In our opinion, the accompanying forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.33 When an accountant examines a projection, his opinion regarding the assumptions should be conditioned on the hypothetical assumptions; that is, he should express an opinion on whether the assumptions provide a reasonable basis for the projection given the hypothetical assumptions. Also, his report should include a separate paragraph that describes the limitations on the usefulness of the presentation. The following is the form of the accountant's standard report on an examination of a projection that does not contain a range.

We have examined the accompanying projected balance sheet, statements of income, retained earnings, and changes in financial position of XYZ

¹⁹ The accountant's report need not comment on the consistency of the application of accounting principles as long as the presentation of any change in accounting principles is in conformity with AICPA presentation guidelines as detailed in the *AICPA Guide for Prospective Financial Statements*.

²⁰ When the presentation is summarized as discussed in Appendix A of this section, this sentence might read "We have examined the accompanying summarized forecast of XYZ Company as of December 31, 19XX, and for the year then ending."

Company as of December 31, 19XX, and for the year then ending.²¹ Our examination was made in accordance with standards for an examination of a projection established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the projection.

The accompanying projection and this report were prepared for [state special purpose, for example, "the DEF National Bank for the purpose of negotiating a loan to expand XYZ Company's plant,"] and should not be used for any other purpose.

In our opinion, the accompanying projection is presented in conformity with guidelines for presentation of a projection established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's projection [describe the hypothetical assumption, for example, "assuming the granting of the requested loan for the purpose of expanding XYZ Company's plant as described in the summary of significant assumptions."] However, even if [describe hypothetical assumption, for example, "the loan is granted and the plant is expanded,"] there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.34 When the prospective financial statements contain a range, the accountant's standard report should also include a separate paragraph that states that the responsible party has elected to portray the expected results of one or more assumptions as a range. The following is an example of the separate paragraph to be added to the accountant's report when he examines prospective financial statements, in this case a forecast, that contain a range.

As described in the summary of significant assumptions, management of XYZ Company has elected to portray forecasted [describe financial statement element or elements for which the expected results of one or more assumptions fall within a range, and identify assumptions expected to fall within a range, for example, "revenue at the amounts of \$X,XXX and \$Y,YYY, which is predicated upon occupancy rates of XX percent and YY percent of available apartments,"] rather than as a single point estimate. Accordingly, the accompanying forecast presents forecasted financial position, results of operations and changes in financial position [describe one or more assumptions expected to fall within a range, for example, "at such occupancy rates."] However, there is no assurance that the actual results will fall within the range of [describe one or more assumptions expected to fall within a range, for example, "occupancy rates"] presented.

²¹ When the presentation is summarized as discussed in Appendix A of this section, this sentence might read "We have examined the accompanying summarized projection of XYZ Company as of December 31, 19XX, and for the year then ending."

.35 The date of completion of the accountant's examination procedures should be used as the date of the report.

Modifications to the Accountant's Opinion

.36 The following circumstances result in the following types of modified accountant's report involving the accountant's opinion:

- a. If, in the accountant's opinion, the prospective financial statements depart from AICPA presentation guidelines, he should issue a qualified opinion (see paragraph .37) or an adverse opinion (see paragraph .39).²² However, if the presentation departs from the presentation guidelines because it fails to disclose assumptions that appear to be significant the accountant should issue an adverse opinion (see paragraphs .39 and .40).
- b. If the accountant believes that one or more significant assumptions do not provide a reasonable basis for the forecast, or a reasonable basis for the projection given the hypothetical assumptions, he should issue an adverse opinion (see paragraph .39).
- c. If the accountant's examination is affected by conditions that preclude application of one or more procedures he considers necessary in the circumstances, he should disclaim an opinion and describe the scope limitation in his report (see paragraph .41).

.37 *Qualified Opinion.* In a qualified opinion, the accountant should state, in a separate paragraph, all of his substantive reasons for modifying his opinion and describe the departure from AICPA presentation guidelines. His opinion should include the words "except" or "exception" as the qualifying language and should refer to the separate explanatory paragraph. The following is an example of an examination report on a forecast that is at variance with AICPA guidelines for presentation of a financial forecast.

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. Our examination was made in accordance with standards for an examination of a forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.

The forecast does not disclose reasons for the significant variation in the relationship between income tax expense and pretax accounting income as required by generally accepted accounting principles.

In our opinion, except for the omission of the disclosure of the reasons for the significant variation in the relationship between income tax expense and pretax accounting income as discussed in the preceding paragraph, the accompanying forecast is presented in conformity with guidelines for

²² However, the accountant may issue the standard examination report on a financial forecast filed with the SEC that meets the presentation requirements of article XI of Regulation S-X.

a presentation of a forecast established by the American Institute of Certified Public Accountants and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.38 Because of the nature, sensitivity, and interrelationship of prospective information, a reader would find an accountant's report qualified for a measurement departure,²³ the reasonableness of the underlying assumptions, or a scope limitation difficult to interpret. Accordingly, the accountant should not express his opinion about these items with language such as "except for ..." or "subject to the effects of" Rather, when a measurement departure, an unreasonable assumption, or a limitation on the scope of the accountant's examination has led him to conclude that he cannot issue an unqualified opinion, he should issue the appropriate type of modified opinion described in paragraphs .39 through .42.

.39 Adverse Opinion. In an adverse opinion the accountant should state, in a separate paragraph, all of his substantive reasons for his adverse opinion. His opinion should state that the presentation is not in conformity with presentation guidelines and should refer to the explanatory paragraph. When applicable, his opinion paragraph should also state that, in the accountant's opinion, the assumptions do not provide a reasonable basis for the prospective financial statements. An example of an adverse opinion on an examination of prospective financial statements is set forth below. In this case, a financial forecast was examined and the accountant's opinion was that a significant assumption was unreasonable. The example should be revised as appropriate for a different type of presentation or if the adverse opinion is issued because the statements do not conform to the presentation guidelines.

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. Our examination was made in accordance with standards for an examination of a financial forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.

As discussed under the caption "Sales" in the summary of significant forecast assumptions, the forecasted sales include, among other things, revenue from the Company's federal defense contracts continuing at the current level. The Company's present federal defense contracts will expire in March 19XX. No new contracts have been signed and no negotiations are under way for new

²³ An example of a measurement departure is the failure to capitalize a capital lease in a forecast where the historical financial statements for the prospective period are expected to be presented in conformity with generally accepted accounting principles.

federal defense contracts. Furthermore, the federal government has entered into contracts with another company to supply the items being manufactured under the Company's present contracts.

In our opinion, the accompanying forecast is not presented in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants because management's assumptions, as discussed in the preceding paragraph, do not provide a reasonable basis for management's forecast. We have no responsibility to update this report for events or circumstances occurring after the date of this report.

.40 If the presentation, including the summary of significant assumptions, fails to disclose assumptions that, at the time, appear to be significant, the accountant should describe the assumptions in his report and issue an adverse opinion. The accountant should not examine a presentation that omits all disclosures of assumptions. Also, the accountant should not examine a financial projection that omits (a) an identification of the hypothetical assumptions or (b) a description of the limitations on the usefulness of the presentation.

.41 *Disclaimer of Opinion.* In a disclaimer of opinion the accountant's report should indicate, in a separate paragraph, the respects in which the examination did not comply with standards for an examination. The accountant should state that the scope of the examination was not sufficient to enable him to express an opinion with respect to the presentation or the underlying assumptions, and his disclaimer of opinion should include a direct reference to the explanatory paragraph. The following is an example of a report on an examination of prospective financial statements, in this case a financial forecast, for which a significant assumption could not be evaluated.

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. Except as explained in the following paragraph, our examination was made in accordance with standards for an examination of a financial forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.

As discussed under the caption "Income From Investee" in the summary of significant forecast assumptions, the forecast includes income from an equity investee constituting 23 percent of forecasted net income, which is management's estimate of the Company's share of the investee's income to be accrued for 19XX. The investee has not prepared a forecast for the year ending December 31, 19XX, and we were therefore unable to obtain suitable support for this assumption.

Because, as described in the preceding paragraph, we are unable to evaluate management's assumption regarding income from an equity investee and other assumptions that depend thereon, we express no opinion with respect to

the presentation of or the assumptions underlying the accompanying forecast. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.42 When there is a scope limitation and the accountant also believes there are material departures from the presentation guidelines, those departures should be described in the accountant's report.

Other Modifications to the Standard Examination Report

.43 The circumstances described below, although not necessarily resulting in modifications to the accountant's opinion, would result in the following types of modifications to the standard examination report.

.44 *Emphasis of a Matter.* In some circumstances, the accountant may wish to emphasize a matter regarding the prospective financial statements but nevertheless intends to issue an unqualified opinion. The accountant may present other information and comments he wishes to include, such as explanatory comments or other informative material, in a separate paragraph of his report.

.45 *Evaluation Based in Part on a Report of Another Accountant.* When more than one accountant is involved in the examination, the guidance provided for that situation in connection with examinations of historical financial statements is generally applicable. When the principal accountant decides to refer to the report of another accountant as a basis, in part, for his own opinion, he should disclose that fact in stating the scope of the examination and should refer to the report of the other accountant in expressing his opinion. Such a reference indicates the division of responsibility for the performance of the examination.

.46 *Comparative Historical Financial Information.* Prospective financial statements may be included in a document that also contains historical financial statements and an accountant's report thereon.²⁴ In addition, the historical financial statements that appear in the document may be summarized and presented with the prospective financial statements for comparative purposes.²⁵ An example of the reference to the accountant's report on the historical financial statements when he examined, reviewed, or compiled those statements is presented in paragraph .22.

.47 *Reporting When the Examination Is Part of a Larger Engagement.* When the accountant's examination of prospective financial statements is part of a larger engagement, for example, a financial feasibility study or

²⁴ The accountant's responsibility with respect to those historical financial statements upon which he is not engaged to perform a professional service is described in section 504, *Association With Financial Statements*, in the case of public entities, and SSARS No. 1, *Compilation and Review of Financial Statements*, paragraphs 5 through 7 [AR section 100.05—.07], in the case of nonpublic entities.

²⁵ Section 552, *Reporting on Condensed Financial Statements and Selected Financial Data*, discusses the accountant's report for summarized financial statements derived from audited financial statements that are not included in the same document.

business acquisition study, it is appropriate to expand the report on the examination of the prospective financial statements to describe the entire engagement.

.48 The following is a report that might be issued when an accountant chooses to expand his report on a financial feasibility study.²⁶

- a. The Board of Directors
Example Hospital
Example, Texas
- b. We have prepared a financial feasibility study of Example Hospital's plans to expand and renovate its facilities. The study was undertaken to evaluate the ability of Example Hospital (the Hospital) to meet the Hospital's operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed \$25,000,000 [*legal title of bonds*] issue, at an assumed average annual interest rate of 10.0 percent during the five years ending December 31, 19X6.
- c. The proposed capital improvements program (the Program) consists of a new two-level addition, which is to provide fifty additional medical-surgical beds, increasing the complement to 275 beds. In addition, various administrative and support service areas in the present facilities are to be remodeled. The Hospital administration anticipates that construction is to begin June 30, 19X2, and to be completed by December 31, 19X3.
- d. The estimated total cost of the Program is approximately \$30,000,000. It is assumed that the \$25,000,000 of revenue bonds that the Example Hospital Finance Authority proposes to issue would be the primary source of funds for the Program. The responsibility for payment of debt service on the bonds is solely that of the Hospital. Other necessary funds to finance the Program are assumed to be provided from the Hospital's funds, from a local fund drive, and from interest earned on funds held by the bond trustee during the construction period.
- e. Our procedures included analysis of—
 - Program history, objectives, timing and financing.
 - The future demand for the Hospital's services, including consideration of—
 - Economic and demographic characteristics of the Hospital's defined service area.
 - Locations, capacities, and competitive information pertaining to other existing and planned area hospitals.
 - Physician support for the Hospital and its programs.

²⁶ Although the entity referred to in the report is a hospital, the form of report is also applicable to other entities such as hotels or stadiums. Also, although the illustrated report format and language should not be departed from in any significant way, the language used should be tailored to fit the circumstances that are unique to a particular engagement (for example, the description of the proposed capital improvement program, paragraph c; the proposed financing of the program, paragraphs b and d; the specific procedures applied by the accountant, paragraph e; and any explanatory comments included in emphasis-of-a-matter paragraphs, paragraph i, which deals with general matter; and paragraph j, which deals with specific matters).

- Historical utilization levels.
 - Planning agency applications and approvals.
 - Construction and equipment costs, debt service requirements, and estimated financing costs.
 - Staffing patterns and other operating considerations.
 - Third-party reimbursement policy and history.
 - Revenue/expense/volume relationships.
- f. We also participated in gathering other information, assisted management in identifying and formulating its assumptions, and assembled the accompanying financial forecast based on those assumptions.
- g. The accompanying financial forecast for the annual periods ending December 31, 19X2, through 19X6, is based on assumptions that were provided by or reviewed with and approved by management. The financial forecast includes—
- Balance sheets.
 - Statements of revenues and expenses.
 - Statements of changes in financial position.
 - Statements of changes in fund balance.
- h. We have examined the financial forecast. Our examination was made in accordance with standards for an examination of a financial forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.
- i. Legislation and regulations at all levels of government have affected and may continue to affect revenues and expenses of hospitals. The financial forecast is based on legislation and regulations currently in effect. If future legislation or regulations related to hospital operations are enacted, such legislation or regulations could have a material effect on future operations.
- j. The interest rate, principal payments, Program costs, and other financing assumptions are described in the section entitled "Summary of Significant Forecast Assumptions and Rationale." If actual interest rates, principal payments, and funding requirements are different from those assumed, the amount of the bond issue and debt service requirements would need to be adjusted accordingly from those indicated in the forecast. If such interest rates, principal payments, and funding requirements are lower than those assumed, such adjustments would not adversely affect the forecast.
- k. Our conclusions are presented below.
- In our opinion, the accompanying financial forecast is presented in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants.
 - In our opinion, the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because

events and circumstances frequently do not occur as expected, and those differences may be material.

- The accompanying financial forecast indicates that sufficient funds could be generated to meet the Hospital's operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed \$25,000,000 bond issue, during the forecast periods. However, the achievement of any financial forecast is dependent on future events, the occurrence of which cannot be assured.

- I. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Applying Agreed-Upon Procedures to Prospective Financial Statements

.49 An accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided that (a) the specified users involved have participated in establishing the nature and scope of the engagement and take responsibility for the adequacy of the procedures to be performed, (b) distribution of the report is to be restricted to the specified users involved, and (c) the prospective financial statements include a summary of significant assumptions.

.50 The accountant who accepts an engagement to apply agreed-upon procedures to prospective financial statements should be independent; have adequate technical training and proficiency to apply agreed-upon procedures to prospective financial statements; adequately plan the engagement and supervise the work of assistants, if any; and obtain sufficient evidence to provide a reasonable basis for his report on the results of applying the agreed-upon procedures.

.51 The accountant's procedures generally may be as limited or extensive as the specified users desire as long as the specified users take responsibility for their adequacy. However, mere reading of prospective financial statements does not constitute a procedure sufficient to permit an accountant to report on the results of applying agreed-upon procedures to such statements.

.52 To satisfy the requirement that the specified users involved participate in establishing the nature and scope of the engagement and take responsibility for the adequacy of the procedures to be performed, the accountant ordinarily should meet with the specified users involved to discuss the procedures to be followed. This discussion may include describing, to the specified users, procedures that are frequently followed in similar types of engagements. Sometimes the accountant may not be able to discuss the procedures directly with all of the specified users who will receive the report. In such circumstances, the accountant may satisfy the requirement that the specified users involved take responsibility for the adequacy of the procedures by applying any one of the following or similar procedures:

- a. Discussing the procedures to be applied with legal counsel or other appropriate designated representatives of the users involved, such as, a trustee, a receiver, or a creditors' committee.
- b. Reviewing relevant correspondence from the specified users.
- c. Comparing the procedures to be applied to written requirements of a supervisory agency.
- d. Distributing a draft of the report or a copy of the client's engagement letter to the specified users involved with a request for their comments before the report is issued.

Working Papers

.53 Although it is not possible to specify the form or content of the working papers that an accountant should prepare in connection with an engagement to apply agreed-upon procedures to prospective financial statements because of the different circumstances of individual engagements, the accountant's working papers ordinarily should indicate that—

- a. The work was adequately planned and supervised.
- b. The agreed-upon procedures were performed as a basis for the report.

Reports on the Results of Applying Agreed-Upon Procedures

.54 The accountant's report on the results of applying agreed-upon procedures should—

- a. Indicate the prospective financial statements covered by the accountant's report.
- b. Indicate that the report is limited in use, intended solely for the specified users, and should not be used by others.
- c. Enumerate the procedures performed and refer to conformity with the arrangements made with the specified users.
- d. If the agreed-upon procedures are less than those performed in an examination, state that the work performed was less in scope than an examination of prospective financial statements in accordance with AICPA standards and disclaim an opinion on whether the presentation of the prospective financial statements is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the forecast, or a reasonable basis for the projection given the hypothetical assumptions.
- e. State the accountant's findings.
- f. Include a caveat that the prospective results may not be achieved.
- g. State that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

.55 Also, the accountant may wish to state in his report that he makes no representation about the sufficiency of the procedures for the specified users' purposes.

.56 When the accountant reports on the results of applying agreed-upon procedures, he should not express any form of negative assurance on the prospective financial statements taken as a whole.

.57 The following two exhibits illustrate reports that might be issued when the engagement is limited to applying agreed-upon procedures to the prospective financial statements.

Exhibit 1

Board of Directors—XYZ Corporation

Board of Directors—ABC Company

At your request, we have performed certain agreed-upon procedures, as enumerated below, with respect to the forecasted balance sheet, statements of income, retained earnings and changes in financial position of DEF Company, a subsidiary of ABC Company, as of December 31, 19XX, and for the year then ending. These procedures, which were specified by the Boards of Directors of XYZ Corporation and ABC Company, were performed solely to assist you in connection with the proposed sale of DEF Company to XYZ Corporation. It is understood that this report is solely for your information and should not be used by those who did not participate in determining the procedures.

- a. With respect to forecasted rental income, we compared the assumptions about expected demand for rental of the housing units to demand for similar housing units at similar rental prices in the city area in which DEF Company's housing units are located.
- b. We tested the forecast for mathematical accuracy.

Because the procedures described above do not constitute an examination of prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants, we do not express an opinion on whether the prospective financial statements are presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions provide a reasonable basis for the presentation.

In connection with the procedures referred to above, no matters came to our attention that caused us to believe that rental income should be adjusted or that the forecast is mathematically inaccurate. Had we performed additional procedures or had we made an examination of the forecast in accordance with standards established by the American Institute of Certified Public Accountants, matters might have come to our attention that would have been reported to you. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Exhibit 2

ABC Trustee

XYZ Company

At your request, we performed the agreed-upon procedures enumerated below with respect to the forecasted balance sheet, statements of income, retained earnings and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. These procedures, which were specified by ABC Trustee and XYZ Company, were performed solely to assist you, and this report is solely for your information and should not be used by those who did not participate in determining the procedures.

- a. We assisted the management of XYZ Company in assembling the prospective financial statements.
- b. We read the prospective financial statements for compliance in regard to format with the presentation guidelines established by the American Institute of Certified Public Accountants for presentation of a forecast.
- c. We tested the forecast for mathematical accuracy.

Because the procedures described above do not constitute an examination of prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants, we do not express an opinion on whether the prospective financial statements are presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions provide a reasonable basis for the presentation.

In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the format of the forecast should be modified or that the forecast is mathematically inaccurate. Had we performed additional procedures or had we made an examination of the forecast in accordance with standards established by the American Institute of Certified Public Accountants, matters might have come to our attention that would have been reported to you. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Other Information

.58 When an accountant's compilation, review, or examination report on historical financial statements is included in an accountant-submitted document containing prospective financial statements, the accountant should either examine, compile, or apply agreed-upon procedures to the prospective financial statements and report accordingly, unless (a) the prospective financial statements are labeled as a "budget," (b) the budget does not extend beyond the end of the current fiscal year, and (c) the budget is presented with interim historical financial statements for the current year. In such circumstances, the accountant need not examine, compile, or apply agreed-upon procedures to the budget; however, he should report on it and (a) indicate that he did not examine or compile the budget and (b) disclaim an

opinion or any other form of assurance on the budget. In addition, the budgeted information may omit the summaries of significant assumptions and accounting policies required by the guidelines for presentation of prospective financial statements established by the American Institute of Certified Public Accountants, provided such omission is not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such budgeted information, and is disclosed in the accountant's report. The following is the form of the standard paragraphs to be added to the accountant's report in this circumstance when the summaries of significant assumptions and accounting policies have been omitted.

The accompanying budgeted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the six months then ending, have not been compiled or examined by us, and, accordingly, we do not express an opinion or any other form of assurance on them.

Management has elected to omit the summaries of significant assumptions and accounting policies required under established guidelines for presentation of prospective financial statements. If the omitted summaries were included in the budgeted information, they might influence the user's conclusions about the company's budgeted information. Accordingly, this budgeted information is not designed for those who are not informed about such matters.

.59 When the accountant's compilation, review, or examination report on historical financial statements is included in a client-prepared document containing prospective financial statements, the accountant should not consent to the use of his name in the document unless (a) he has examined, compiled, or applied agreed-upon procedures to the prospective financial statements and his report accompanies them, (b) the prospective financial statements are accompanied by an indication by the responsible party or the accountant that the accountant has not performed such a service on the prospective financial statements and that the accountant assumes no responsibility for them, or (c) another accountant has examined, compiled, or applied agreed-upon procedures to the prospective financial statements and his report is included in the document. In addition, if the accountant has examined the historical financial statements and they accompany prospective financial statements that he did not examine, compile, or apply agreed-upon procedures to in certain ²⁷ client-prepared documents, he should refer to section 550, *Other Information in Documents Containing Audited Financial Statements*.

²⁷ Section 550 applies only to such prospective financial statements contained in (a) annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Securities Exchange Act of 1934 or (b) other documents to which the auditor, at the client's request, devotes attention. Section 550 does not apply when the historical financial statements and report appear in a registration statement filed under the Securities Act of 1933 (in which case, see section 711, *Filings Under Federal Securities Statutes*).

.60 The accountant whose report on prospective financial statements is included in a client-prepared document containing historical financial statements should not consent to the use of his name in the document unless (a) he has compiled, reviewed, or examined the historical financial statements and his report accompanies them, (b) the historical financial statements are accompanied by an indication by the responsible party or the accountant that the accountant has not performed such a service on the historical financial statements and that the accountant assumes no responsibility for them, or (c) another accountant has compiled, reviewed, or examined the historical financial statements and his report is included in the document.

.61 An entity may publish various documents that contain information other than historical financial statements in addition to the compiled or examined prospective financial statements and the accountant's report thereon. The accountant's responsibility with respect to information in such a document does not extend beyond the financial information identified in the report, and he has no obligation to perform any procedures to corroborate other information contained in the document. However, the accountant should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the prospective financial statements.

.62 If the accountant examines prospective financial statements included in a document containing inconsistent information, he might not be able to conclude that there is adequate support for each significant assumption. The accountant should consider whether the prospective financial statements, his report, or both require revision. Depending on the conclusion he reaches, the accountant should consider other actions that may be appropriate, such as issuing an adverse opinion, disclaiming an opinion because of a scope limitation, withholding the use of his report in the document, or withdrawing from the engagement.

.63 If the accountant compiles the prospective financial statements included in the document containing inconsistent information, he should attempt to obtain additional or revised information. If he does not receive such information, the accountant should withhold the use of his report or withdraw from the compilation engagement.

.64 If, while reading the other information appearing in the document containing the examined or compiled prospective financial statements, as described in the preceding paragraphs, the accountant becomes aware of information that he believes is a material misstatement of fact that is not an inconsistent statement, he should discuss the matter with the responsible party. In connection with this discussion, the accountant should consider that he may not have the expertise to assess the validity of the statement made, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion. If the accountant concludes that he has a valid basis for concern, he should propose that the responsible party consult with some other party whose advice might be useful, such as the entity's legal counsel.

.65 If, after discussing the matter as described in paragraph .64, the accountant concludes that a material misstatement of fact remains, the action he takes will depend on his judgment in the particular circumstances. He should consider steps such as notifying the responsible party in writing of his views concerning the information and consulting his legal counsel about further appropriate action in the circumstances.

Effective Date

.66 This section is effective for engagements in which the date of completion of the accountant's services on prospective financial statements is September 30, 1986, or later. Earlier application is encouraged.

Appendix A

.67 Minimum Presentation Guidelines

1. Prospective information presented in the format of historical financial statements facilitates comparisons with financial position, results of operations, and changes in financial position of prior periods, as well as those actually achieved for the prospective period. Accordingly, prospective financial statements preferably should be in the format of the historical financial statements that would be issued for the period(s) covered unless there is an agreement between the responsible party and potential users specifying another format. Prospective financial statements may take the form of complete basic financial statements¹ or may be limited to the following minimum items (where such items would be presented for historical financial statements for the period).²

- a. Sales or gross revenues
- b. Gross profit or cost of sales
- c. Unusual or infrequently occurring items
- d. Provision for income taxes
- e. Discontinued operations or extraordinary items
- f. Income from continuing operations
- g. Net income
- h. Primary and fully diluted earnings per share
- i. Significant changes in financial position³
- j. A description of what management intends the prospective financial statements to present, a statement that the assumptions are based on information about circumstances and conditions existing at the time the prospective information was prepared, and a caveat that the prospective results may not be achieved
- k. Summary of significant assumptions

Note: This appendix describes the minimum items that constitute a presentation of a financial forecast or a financial projection, as specified in the *AICPA Guide for Prospective Financial Statements*. Complete presentation guidelines for entities that choose to issue prospective financial statements, together with illustrative presentations, are included in the guide.

¹ The details of each statement may be summarized or condensed so that only the major items in each are presented. The usual footnotes associated with historical financial statements need not be included as such. However, significant assumptions and accounting policies should be disclosed.

² Similar types of financial information should be presented for entities for which these terms do not describe operations. Further, similar items should be presented if a comprehensive basis of accounting other than generally accepted accounting principles is used to present the prospective financial statements. For example, if the cash basis were used, item a would be cash receipts.

³ This item does not require a balance sheet or a statement of changes in financial position. Examples are included in the *AICPA Guide for Prospective Financial Statements*.

1. Summary of significant accounting policies
2. A presentation that omits one or more of the applicable minimum items *a* through *i* above is a partial presentation, which would not ordinarily be appropriate for general use. If an omitted applicable minimum item is derivable from the information presented, the presentation would not be deemed to be a partial presentation.⁴ A presentation that contains the applicable minimum items *a* through *i* above, but omits minimum items *j* through *l* above is not a partial presentation, and an engagement involving such a presentation is subject to the provisions of this section.

⁴ The accountant who provides services with respect to a partial presentation should consider the reporting guidance in the AICPA Code of Professional Ethics, rule 201(e) [ET section 201.01] and interpretation 201-2 [ET section 201.03].

Appendix B

.68 Training and Proficiency, Planning and Procedures Applicable to Compilations

Training and Proficiency

1. The accountant should be familiar with the guidelines for the preparation and presentation of prospective financial statements. The guidelines are contained in the *AICPA Guide for Prospective Financial Statements*.

2. The accountant should possess or obtain a level of knowledge of the industry and the accounting principles and practices of the industry in which the entity operates, or will operate, that will enable him to compile prospective financial statements that are in appropriate form for an entity operating in that industry.

Planning the Compilation Engagement

3. To compile the prospective financial statements of an existing entity, the accountant should obtain a general knowledge of the nature of the entity's business transactions and the key factors upon which its future financial results appear to depend. He should also obtain an understanding of the accounting principles and practices of the entity to determine if they are comparable to those used within the industry in which the entity operates.

4. To compile the prospective financial statements of a proposed entity, the accountant should obtain knowledge of the proposed operations and the key factors upon which its future results appear to depend and that have affected the performance of entities in the same industry.

Compilation Procedures

5. In performing a compilation of prospective financial statements the accountant should, where applicable—

- a. Establish an understanding with the client, preferably in writing, regarding the services to be performed.
- b. Inquire about the accounting principles used in the preparation of the prospective financial statements.
 - For existing entities, compare the accounting principles used to those used in the preparation of previous historical financial statements and inquire whether such principles are the same as those expected to be used in the historical financial statements covering the prospective period.
 - For entities to be formed or entities formed that have not commenced operations, compare specialized industry accounting principles used, if any, to those typically used in the industry. Inquire about whether the accounting principles used

for the prospective financial statements are those that are expected to be used when, or if, the entity commences operations.

- c. Ask how the responsible party identifies the key factors and develops its assumptions.
- d. List, or obtain a list of, the responsible party's significant assumptions providing the basis for the prospective financial statements and consider whether there are any obvious omissions in light of the key factors upon which the prospective results of the entity appear to depend.
- e. Consider whether there appear to be any obvious internal inconsistencies in the assumptions.
- f. Perform, or test the mathematical accuracy of, the computations that translate the assumptions into prospective financial statements.
- g. Read the prospective financial statements, including the summary of significant assumptions, and consider whether—
 - The statements, including the disclosures of assumptions and accounting policies, appear to be not presented in conformity with the AICPA presentation guidelines for prospective financial statements.¹
 - The statements, including the summary of significant assumptions, appear to be not obviously inappropriate in relation to the accountant's knowledge of the entity and its industry and, for a—

Financial forecast, the expected conditions and course of action in the prospective period.

Financial projection, the purpose of the presentation.

- h. If a significant part of the prospective period has expired, inquire about the results of operations or significant portions of the operations (such as sales volume), and significant changes in financial position, and consider their effect in relation to the prospective financial statements. If historical financial statements have been prepared for the expired portion of the period, the accountant should read such statements and consider those results in relation to the prospective financial statements.
- i. Confirm his understanding of the statements (including assumptions) by obtaining written representations from the responsible party. Because the amounts reflected in the statements are not supported by historical books and records but rather by assumptions, the accountant should obtain representations in which the responsible party indicates its responsibility for the assumptions. The representations should be signed by the responsible party at the highest level of authority who the accountant believes is responsible for and knowledgeable, directly or through others, about matters covered by the representations.
 - For a financial forecast, the representations should include a statement that the financial forecast presents, to the best of the

¹ Presentation guidelines for entities that issue prospective financial statements are set forth and illustrated in the AICPA *Guide for Prospective Financial Statements*.

responsible party's knowledge and belief, the expected financial position, results of operations, and changes in financial position for the forecast period and that the forecast reflects the responsible party's judgment, based on present circumstances, of the expected conditions and its expected course of action. If the forecast contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

- *For a financial projection*, the representations should include a statement that the financial projection presents, to the best of the responsible party's knowledge and belief, the expected financial position, results of operations, and changes in financial position for the projection period given the hypothetical assumptions, and that the projection reflects its judgment, based on present circumstances, of expected conditions and its expected course of action given the occurrence of the hypothetical events. The representations should also (i) identify the hypothetical assumptions and describe the limitations on the usefulness of the presentation, (ii) state that the assumptions are appropriate, (iii) indicate if the hypothetical assumptions are improbable, and (iv) if the projection contains a range, include a statement that, to the best of the responsible party's knowledge and belief, given the hypothetical assumptions, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.
- j. Consider, after applying the above procedures, whether he has received representations or other information that appears to be obviously inappropriate, incomplete, or otherwise misleading and, if so, attempt to obtain additional or revised information. If he does not receive such information, the accountant should ordinarily withdraw from the compilation engagement.² (Note that the omission of disclosures, other than those relating to significant assumptions, would not require the accountant to withdraw; see paragraph .24 of this section.)

² The accountant need not withdraw from the engagement if the effect of such information on the prospective financial statements does not appear to be material.

Appendix C

.69 Training and Proficiency, Planning and Procedures Applicable to Examinations

Training and Proficiency

1. The accountant should be familiar with the guidelines for the preparation and presentation of prospective financial statements. The guidelines are contained in the *AICPA Guide for Prospective Financial Statements*.

2. The accountant should possess or obtain a level of knowledge of the industry and the accounting principles and practices of the industry in which the entity operates, or will operate, that will enable him to examine prospective financial statements that are in appropriate form for an entity operating in that industry.

Planning an Examination Engagement

3. Planning the examination engagement involves developing an overall strategy for the expected scope and conduct of the engagement. To develop such a strategy, the accountant needs to have sufficient knowledge to enable him to adequately understand the events, transactions, and practices that, in his judgment, may have a significant effect on the prospective financial statements.

4. Factors to be considered by the accountant in planning the examination include (a) the accounting principles to be used and the type of presentation, (b) the anticipated level of attestation risk¹ related to the prospective financial statements, (c) preliminary judgments about materiality levels, (d) items within the prospective financial statements that are likely to require revision or adjustment, (e) conditions that may require extension or modification of the accountant's examination procedures, (f) knowledge of the entity's business and its industry, (g) the responsible party's experience in preparing prospective financial statements, (h) the length of the period covered by the prospective financial statements, and (i) the process by which the responsible party develops its prospective financial statements.

¹ *Attestation risk* is the risk that the accountant may unknowingly fail to appropriately modify his examination report on prospective financial statements that are materially misstated, that is, that are not presented in conformity with AICPA presentation guidelines or have assumptions that do not provide a reasonable basis for management's forecast, or management's projection given the hypothetical assumptions. It consists of (a) the risk (consisting of inherent risk and control risk) that the prospective financial statements contain errors that could be material and (b) the risk (detection risk) that the accountant will not detect such errors.

5. The accountant should obtain knowledge of the entity's business, accounting principles, and the key factors upon which its future financial results appear to depend. The accountant should focus on such areas as—

- a. The availability and cost of resources needed to operate. Principal items usually include raw materials, labor, short-term and long-term financing, and plant and equipment.
- b. The nature and condition of markets in which the entity sells its goods or services, including final consumer markets if the entity sells to intermediate markets.
- c. Factors specific to the industry, including competitive conditions, sensitivity to economic conditions, accounting policies, specific regulatory requirements, and technology.
- d. Patterns of past performance for the entity or comparable entities, including trends in revenue and costs, turnover of assets, uses and capacities of physical facilities, and management policies.

Examination Procedures

6. The accountant and the responsible party should reach an understanding regarding the services to be provided. Ordinarily, this understanding is confirmed in an engagement letter.

7. The accountant's objective in an examination of prospective financial statements is to accumulate sufficient evidence to limit attestation risk to a level that is, in his professional judgment, appropriate for the level of assurance that may be imparted by his examination report. In a report on an examination of prospective financial statements, he provides assurance only about whether the prospective financial statements are presented in conformity with AICPA presentation guidelines and whether the assumptions provide a reasonable basis for management's forecast, or a reasonable basis for management's projection given the hypothetical assumptions. He does not provide assurance about the achievability of the prospective results because events and circumstances frequently do not occur as expected and achievement of the prospective results is dependent on the actions, plans, and assumptions of the responsible party.

8. In his examination of prospective financial statements, the accountant should select from all available procedures—that is, procedures that assess inherent and control risk and restrict detection risk—any combination that can limit attestation risk to such an appropriate level. The extent to which examination procedures will be performed should be based on the accountant's consideration of (a) the nature and materiality of the information to the prospective financial statements taken as a whole; (b) the likelihood of misstatements; (c) knowledge obtained during current and previous engagements; (d) the responsible party's competence with respect to prospective financial statements; (e) the extent to which the prospective financial statements are affected by the responsible party's judgment, for example, its judgment in selecting the assumptions used to prepare the prospective financial statements; and (f) the adequacy of the responsible party's underlying data.

9. The accountant should perform those procedures he considers necessary in the circumstances to report on whether the assumptions provide a reasonable basis for the—

- a. *Financial forecast.* The accountant can form an opinion that the assumptions provide a reasonable basis for the forecast if the responsible party represents that the presentation reflects, to the best of its knowledge and belief, its estimate of expected financial position, results of operations, and changes in financial position for the prospective period² and the accountant concludes, based on his examination, (i) that the responsible party has explicitly identified all factors expected to materially affect the operations of the entity during the prospective period and has developed appropriate assumptions with respect to such factors³ and (ii) that the assumptions are suitably supported.
- b. *Financial projection* given the hypothetical assumptions. The accountant can form an opinion that the assumptions provide a reasonable basis for the financial projection given the hypothetical assumptions if the responsible party represents that the presentation reflects, to the best of its knowledge and belief, expected financial position, results of operations, and changes in financial position for the prospective period given the hypothetical assumptions⁴ and the accountant concludes, based on his examination, (i) that the responsible party has explicitly identified all factors that would materially affect the operations of the entity during the prospective period if the hypothetical assumptions were to materialize and has developed appropriate assumptions with respect to such factors and (ii) that the other assumptions are suitably supported given the hypothetical assumptions. However, as the number and significance of the hypothetical assumptions increase, the accountant may not be able to satisfy himself about the presentation as a whole by obtaining support for the remaining assumptions.

10. The accountant should evaluate the support for the assumptions.

- a. *Financial forecast*—The accountant can conclude that assumptions are suitably supported if the preponderance of information supports each significant assumption.
- b. *Financial projection*—In evaluating support for assumptions other than hypothetical assumptions, the accountant can conclude that they are suitably supported if the preponderance of information supports each significant assumption given the hypothetical assumptions. The accountant need not obtain support for the hypothetical assumptions, although he should consider whether they are consistent with the purpose of the presentation.

² If the forecast contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

³ An attempt to list all assumptions is inherently not feasible. Frequently, basic assumptions that have enormous potential impact are considered to be implicit, such as conditions of peace and absence of natural disasters.

⁴ If the projection contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, given the hypothetical assumptions, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

11. In evaluating the support for assumptions, the accountant should consider—

- a. Whether sufficient pertinent sources of information about the assumptions have been considered. Examples of external sources the accountant might consider are government publications, industry publications, economic forecasts, existing or proposed legislation, and reports of changing technology. Examples of internal sources are budgets, labor agreements, patents, royalty agreements and records, sales backlog records, debt agreements, and actions of the board of directors involving entity plans.
- b. Whether the assumptions are consistent with the sources from which they are derived.
- c. Whether the assumptions are consistent with each other.
- d. Whether the historical financial information and other data used in developing the assumptions are sufficiently reliable for that purpose. Reliability can be assessed by inquiry and analytical or other procedures, some of which may have been completed in past examinations or reviews of the historical financial statements. If historical financial statements have been prepared for an expired part of the prospective period, the accountant should consider the historical data in relation to the prospective results for the same period, where applicable. If the prospective financial statements incorporate such historical financial results and that period is significant to the presentation, the accountant should make a review of the historical information in conformity with the applicable standards for a review.⁵
- e. Whether the historical financial information and other data used in developing the assumptions are comparable over the periods specified or whether the effects of any lack of comparability were considered in developing the assumptions.
- f. Whether the logical arguments or theory, considered with the data supporting the assumptions, are reasonable.

12. In evaluating the preparation and presentation of the prospective financial statements, the accountant should perform procedures that will provide reasonable assurance that the—

- a. Presentation reflects the identified assumptions.
- b. Computations made to translate the assumptions into prospective amounts are mathematically accurate.
- c. Assumptions are internally consistent.
- d. Accounting principles used in the—
 - *Financial forecast* are consistent with the accounting principles expected to be used in the historical financial statements covering the prospective period and those used in the most recent historical financial statements, if any.

⁵ If the entity is a public company, the accountant should perform the procedures in section 722, *Review of Interim Financial Information*, paragraphs .06 through .15. If the entity is nonpublic, the accountant should perform the procedures in SSARS No. 1, *Compilation and Review of Financial Statements*, paragraphs 24 through 31 [AR section 100.24—31].

- *Financial projection* are consistent with the accounting principles expected to be used in the prospective period and those used in the most recent historical financial statements, if any, or that they are consistent with the purpose of the presentation.⁶
- e. Presentation of the prospective financial statements follows the AICPA guidelines applicable for such statements.⁷
- f. Assumptions have been adequately disclosed based on AICPA presentation guidelines for prospective financial statements.

13. The accountant should consider whether the prospective financial statements, including related disclosures, should be revised because of (a) mathematical errors, (b) unreasonable or internally inconsistent assumptions, (c) inappropriate or incomplete presentation, or (d) inadequate disclosure.

14. The accountant should obtain written representations from the responsible party acknowledging its responsibility for both the presentation and the underlying assumptions. The representations should be signed by the responsible party at the highest level of authority who the accountant believes is responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations. Appendix B, paragraph 5*i* describes the specific representations to be obtained for a financial forecast and a financial projection.

⁶ The accounting principles used in a financial projection need not be those expected to be used in the historical financial statements for the prospective period if use of different principles is consistent with the purpose of the presentation.

⁷ Presentation guidelines for entities that issue prospective financial statements are set forth and illustrated in the AICPA *Guide for Prospective Financial Statements*.

AU Section 9000

AUDITING INTERPRETATIONS

The staff of the Auditing Standards Division has been authorized to issue Interpretations to provide timely guidance on the application of pronouncements of the Auditing Standards Board. Interpretations are reviewed by members of that Board. An Interpretation is not as authoritative as a pronouncement of the Auditing Standards Board, but members should be aware that they may have to justify a departure from an Interpretation if the quality of their work is questioned.

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AU Section 9311**Planning and Supervision:
Auditing Interpretations
of AU Section 311****1. Communications Between the Auditor and Firm Personnel Responsible for Non-Audit Services**

.01 *Question*—Section 311.04(b), *Planning and Supervision*, lists the following procedure that an auditor may consider in planning an examination: "Discussing matters that may affect the examination with firm personnel responsible for non-audit services to the entity".

.02 What specific things should the auditor consider in performing this procedure?

.03 *Interpretation*—The auditor should consider the nature of non-audit services that have been performed. He should assess whether the services involve matters that might be expected to affect the entity's financial statements or the performance of the audit, for example, tax planning or recommendations on a cost accounting system. If the auditor decides that the performance of the non-audit services or the information likely to have been gained from it may have implications for his examination, he should discuss the matter with personnel who rendered the services and consider how the expected conduct and scope of his examination may be affected. In some cases, the auditor may find it useful to review the pertinent portions of the work papers prepared for the non-audit engagement as an aid in determining the nature of the services rendered or the possible audit implications.

[Issue Date: February, 1980.]

2. Planning Considerations for an Audit of a Federally Assisted Program

.04 *Question*—The first standard of field work states that "the work is to be adequately planned," and section 311, *Planning and Supervision*, gives guidance on planning considerations. Section 311.03 states that, "In planning the examination, the auditor should consider . . . Matters relating to the entity's business and the industry in which it operates . . . and the nature of reports expected to be rendered." Section 311.07 states that the auditor should obtain knowledge of matters that relate to the entity's business and its organization, as well

as matters that affect the industry in which it operates, such as government regulations, as they relate to his examination.

.05 What particular matters should the auditor consider in planning the audit of a federally assisted program?

.06 *Interpretation*—The auditor should be aware of governmental standards for audits of federally assisted programs. These standards may be found in the publication of the U. S. General Accounting Office (GAO) entitled *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*.¹ In planning the audit, the auditor should be aware that GAO standards frequently extend beyond the AICPA's generally accepted auditing standards, particularly in the following areas:

- ☐ Working papers.
- ☐ Notification of parties other than the entity's management about irregularities and illegal acts.

.07 Other matters of particular concern in planning an audit of a federally assisted program include:

- ☐ Determination of the type of engagement to be performed.
- ☐ Identification of the entity.
- ☐ Determination of the nature of the financial information to be audited and the appropriate form of reporting.
- ☐ Identification of the parties to whom the auditor has reporting obligations.
- ☐ Consideration of participant eligibility requirements.

.08 *Working papers*—According to section 339, *Working Papers*, the quantity, type, and content of working papers should fit the circumstances of the engagement. In the audit of a federally assisted program, these circumstances include access by governmental audit staffs to the working papers and the GAO's requirement to document the supervisory review. The GAO's standards require working papers that are clear and understandable without supplementary oral explanations.² Thus, the working papers should not consist solely of work programs or checklists on which the auditor has indicated the steps that have been performed. In accordance with section 339.01, the auditor's working papers should be in sufficient

¹ The GAO has proposed revisions to the current edition of its standards.

² The General Accounting Office publication entitled *Guidelines for Financial and Compliance Audits of Federally Assisted Programs* (Washington, D. C.: Government Printing Office, 1980), pp. 12-16, 36-50, gives recommendations on documentation of the review of internal accounting control and tests of account balances and transactions.

detail to provide a record of the work he has done and the conclusions he has reached. Section 339.03 lists appropriate forms of documentation in addition to work programs and checklists, such as analyses, memoranda, and commentaries and schedules. [As modified by the issuance of Statement on Auditing Standards No. 41.] (See section 339.)

.09 The working papers should document significant aspects of the examination. For example, they should document the auditor's study and evaluation of the system of internal accounting control as a basis for reliance thereon in determining the nature, timing, and extent of substantive audit tests. They should identify the nature, source, and amounts of the accounting entries or financial items tested and any related evidential matter examined. In addition, working papers should describe the nature of testing procedures performed and provide detailed information about exceptions found and their disposition. Also, the working papers should show that the work of any assistants has been reviewed.

.10 *Notification of Parties Other Than the Entity's Management About Irregularities and Illegal Acts*—The auditor should be aware that governmental standards go beyond AICPA auditing standards as they relate to notification when the examination indicates that irregularities or illegal acts may exist.

.11 Section 327, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*, paragraph .14 (see Appendix G), states that the auditor should discuss such matters with an appropriate level of management that is at least one level above the level of those involved. Neither section 327 (see Appendix G) nor section 328, *Illegal Acts by Clients* (see Appendix G), requires the auditor to notify parties other than personnel within the client's organization. For example, section 328.19 (see Appendix G) states that, "Generally, the auditor is under no obligation to notify those parties," and that the decision to notify other parties is the responsibility of management.

.12 Governmental requirements, however, call for the auditor not only to promptly report instances of irregularities to the audited entity's management officials above the level of involvement, but also to report the matter to the funding agency or other specified agency.* The management of the entity being audited typically is aware of this reporting requirement.

* In October 1979, the Office of Management and Budget (OMB) issued *Attachment P—Audit Requirements* to its Circular A-102, *Uniform Administrative Requirements for Grants-in-Aid to State and Local Governments* (supplemented and revised in August and September 1980). *Attachment P* gives the OMB the authority to designate a "cognizant agency" to be assigned the audit responsibility for major recipient organizations. *Attachment P* states that the responsibilities of the cognizant agency include acting as a liaison among federal agencies, independent auditors, and recipient organizations, receiving audit reports of the recipient organization and reviewing and distributing them to appropriate federal audit officials, and reviewing notification of irregularities from auditors and informing other affected audit agencies.

.13 Section 327.14 (see Appendix G) and section 328.18—.19 (see Appendix G) discuss situations in which the auditor may wish to consult with his legal counsel about withdrawing from the engagement. This guidance would also be appropriate in the audit of a federally assisted program. However, it would not be appropriate for the auditor to withdraw from the engagement without first reporting the irregularity or illegal act to management and appropriate federal agencies.

.14 In an audit of a federally assisted program, the auditor may find instances of non-compliance with the terms of a grant award which by their nature are not irregularities or illegal acts. In those situations the auditor should disclose significant instances of non-compliance in his report, but ordinarily he would not have to otherwise notify the federal agency.

.15 *Determination of the Type of Engagement to Be Performed*—Section 311.03—.04 states that, "Audit planning involves developing an overall strategy for the expected conduct and scope of the examination," and that the auditor "may consider . . . discussing the type, scope and timing of the examination with management of the entity . . .".

.16 The discussion with management should include an agreement about which of the various types of engagement will be performed, since the GAO's standards address three types of engagement, any combination of which a federal agency may request the auditor to perform. The first type of engagement is an examination of financial statements and an evaluation of compliance with laws and regulations; the second type concerns efficiency and economy in the use of resources; and the third type considers whether desired program results are effectively achieved. If the auditor is requested to examine financial statements and issue a report on them without also reporting on the evaluation of compliance, he should see if management is aware that such a report might not be acceptable to the GAO, the funding agency, or the agency requiring the audit. If a contract, proposal, or engagement letter is used, the auditor may want to consider including in it a clear statement as to the type of engagement and whether that engagement is intended to meet a federal agency's requirements or has been approved by the appropriate federal agency.

.17 *Identification of the Entity*—Obtaining knowledge of the entity's organization, as required by section 311.07 is particularly important when the entity receives funds under several governmental assistance programs. The auditor should discuss and reach agreement with management and, if he considers it necessary, with the appropriate federal agency, as to the grants or programs to be audited. If a contract, proposal, or engagement letter is issued, it should set forth the understanding as to the grants or programs to be audited.*

* *Attachment P* requires that audits of financial operations of state and local government entities that receive federal aid are to be made on an organization-wide basis rather than on a grant-by-grant basis.

.18 *Determination of the Nature of Financial Information to be Audited and the Appropriate Form of Reporting*—In considering the nature of reports expected to be rendered, as required by section 311.03(h), the auditor should be aware that in a financial and compliance audit of a federally assisted program his reporting responsibilities may encompass (a) financial statements of one or more programs, (b) financial statements of an organization having one or more federally assisted programs (an “organization-wide” audit),⁵ or (c) selected financial information such as specified elements, accounts, or items of a financial statement of a federally assisted program. [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

.19 The financial statements or information may be presented in accordance with generally accepted accounting principles or on a comprehensive basis of accounting other than generally accepted accounting principles, such as the cash basis or a basis of accounting prescribed by a regulatory agency.

.20 In deciding between the standard form of auditor’s report given in section 509 (see Appendix G) or some other form of report, the auditor should consider whether the statements constitute complete financial statements and whether they have been prepared in accordance with generally accepted accounting principles.

.21 The auditor should follow the guidance in section 621, *Special Reports*, paragraphs .02—.08, when the financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles. He should look to section 621.09—.14, “Reports on Specified Elements, Accounts or Items of a Financial Statement,” and the related auditing interpretations when he concludes that the statements or information do not constitute complete financial statements.

.22 If the auditor concludes that financial statements that a federal agency requires to be presented on a prescribed form are in fact presented on a comprehensive basis of accounting other than generally accepted accounting principles, he should follow the guidance in section 621.02—.08, and the related auditing interpretations.

.23 If the auditor is required to report on other financial information in addition to the basic financial statements, he should follow the guidance in section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*.

.24 An entity may have several grants or programs, each with separate reporting requirements that may not be met by a report on the entity’s basic financial statements. In such circumstances the

⁵ See footnote 4.

auditor should consider rendering reports on the individual grants or programs, assuming that the scope of his audit is sufficient for him to do so.

.25 When a federal agency audit guide specifies the wording of the auditor's report (for example, on a preprinted form or schedule), the auditor should consider whether that wording calls for assertions that are not consistent with his function or responsibility as described in the contract, proposal, or engagement letter. If there is an inconsistency, the auditor should consider revising the planned work or the wording of the audit report as called for in section 621.20—.21.

.26 In all of the situations discussed above, the auditor should be familiar with the GAO's reporting standards as well as the requirements of the applicable federal agency. The GAO's standards call for a report that contains an opinion on the financial statements, and explanations of violations of legal or regulatory requirements.

.27 *Identification of the Parties to Whom the Auditor Has Reporting Obligations*—To fulfill the requirements of section 311 (regarding the knowledge of the industry and government regulations) when auditing federally assisted programs, the auditor should obtain an understanding of his reporting obligations to parties other than management of the audited entity. A governmental agency may allow, or even require, the entity being audited to make the audit arrangements with the auditor; however, the agency may still expect the auditor to fulfill its requirements, such as submitting the audit report and reporting irregularities to the agency.⁶ Also, the auditor may have a reporting obligation to more than one agency. For example, a local housing authority may be the contracting agency for an audit of a housing grant, the Department of Housing and Urban Development may be the funding agency, and both may have reporting requirements.

.28 *Consideration of Participant Eligibility Requirements*—In planning the scope of the examination, the auditor should obtain knowledge of the nature of the entity's business and consider matters affecting the industry in which it operates, including government regulations, as they relate to the examination.

.29 The nature of some federally financed or sponsored programs is to provide financial assistance to eligible individuals. The eligibility requirements for participation in the program usually are specified in laws, regulations, or contracts applicable to the program.

.30 Section 328, *Illegal Acts by Clients*, paragraph .07 (see Appendix G), discusses the need to consider compliance with laws and regulations. It states that "As part of his examination, the auditor

⁶ See paragraphs .10—.14 of this auditing interpretation entitled "Notification of Parties Other than the Entity's Management About Irregularities and Illegal Acts."

considers laws and regulations that have a direct effect on amounts presented in financial statements,” and states as an example that “applicable laws or regulations may affect the amount of revenue accrued under government contracts.”

.31 Thus, the auditor should plan his audit to test compliance with those laws, regulations, or contractual terms that set forth the requirements for individuals who receive payments under the program. The specific audit objective is to determine that amounts classified in the financial statements as “public assistance expenditures” (or a similar description) should include only expenditures to persons entitled to receive public assistance.

.32 In the audit of a student loan program, for example, the auditor should test not only whether payments were made to students but also whether the students met the funding agency’s eligibility requirements on matters such as financial need.

.33 If the auditor concludes, on the basis of the evidential matter obtained, that the financial statements should, but do not properly include and classify a liability for payments made to ineligible persons, he should consider the need to qualify his opinion for a departure from generally accepted accounting principles. If he is unable to obtain sufficient evidential matter to form a conclusion concerning the eligibility of persons receiving payments, he should consider whether to express a qualified opinion or disclaim an opinion because of a limitation on the scope of his examination.

.34 The auditor should also consider the need to explain in his report violations of regulatory requirements, including instances of noncompliance with eligibility requirements, as required by the GAO’s auditing standards.

[Issue Date: April, 1981.]

3. Responsibility of Assistants for the Resolution of Accounting and Auditing Issues

.35 *Question*—Section 311.14, *Planning and Supervision*, states, “The auditor with final responsibility for the examination and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the examination.” What are the responsibilities of assistants when there are disagreements or concerns with respect to accounting and auditing issues of significance to the financial statements or auditor’s report?

.36 *Response*—Rule 201 of the Code of Professional Ethics [ET section 201.01] states that “a member shall exercise due professional

care in the performance of an engagement.” The discussion of the third general standard states that “due care imposes a responsibility upon each person within an independent auditor’s organization to observe the standards of field work and reporting.” The first general standard requires assistants to meet the responsibility attached to the work assigned to them.

.37 Accordingly, each assistant has a professional responsibility to bring to the attention of appropriate individuals in the firm, disagreements or concerns the assistant might have with respect to accounting and auditing issues that he believes are of significance to the financial statements or auditor’s report, however those disagreements or concerns may have arisen. In addition, each assistant should have a right to document his disagreement if he believes it is necessary to disassociate himself from the resolution of the matter.

[Issue Date: February, 1986.]

AU Section 9315***Communications Between Predecessor and Successor Auditors: Auditing Interpretations of AU Section 315*****1. Determining the Predecessor Auditor**

.01 *Question*—Section 315, *Communications Between Predecessor and Successor Auditors*, requires that before accepting an audit engagement an auditor attempt certain communications with the predecessor auditor. Occasionally, a successor auditor is replaced before completing an audit engagement and issuing a report. In such cases, is another auditor who is considering accepting the engagement required to communicate with the original auditor, the successor auditor who is being replaced, or both?

.02 *Interpretation*—Both. The situation described is unusual and the auditor who is considering accepting the engagement needs complete information to help him decide whether to accept it. To obtain complete information, he should attempt to communicate with both the original auditor and the one he is replacing. That is, both auditors are considered to be predecessor auditors.

.03 In such circumstances, the second successor auditor should make specific and reasonable inquiries of each predecessor auditor regarding matters that the successor believes will assist him in determining whether to accept the engagement. Inquiring of only one of the predecessor auditors would not result in a full response because the circumstances surrounding each change in auditors may be different and the predecessor auditors, having served at different times and for different lengths of time, may have different knowledge about the potential client. In addition, inquiring of each predecessor is relevant since both auditor changes occurred during the period since the issuance of the most recent audit report.

.04 For a publicly held client, the successor might supplement direct inquiries by reviewing any SEC forms 8-K filed regarding auditor changes and any related letters filed with the SEC by the predecessor auditors.

.05 Each predecessor auditor should respond promptly and fully, on the basis of facts known to him, to the successor's reasonable inquiries. A predecessor auditor would not be responding fully when his response is evasive or omits significant information. If either predecessor auditor, due to unusual circumstances, limits his response,

he should inform the successor auditor of the limitation and the successor should consider the implications of such a limitation in light of information of which he is aware.

[Issue Date: May, 1985.]

2. Restating Financial Statements Reported on by a Predecessor Auditor

.06 *Question*—Occasionally, a successor auditor becomes aware of information that leads him to believe that prior period financial statements reported on by a predecessor auditor require restatement. Is it necessary in such a situation for the successor auditor to discuss the information with the predecessor auditor before referring to the restatement adjustments made to the previously issued financial statements?

.07 *Answer*—Yes. The successor auditor should discuss with the predecessor auditor information that he believes requires restatement of the financial statements because such information may have been considered by the predecessor auditor. The successor auditor should communicate to the predecessor any information that the predecessor auditor may need to consider in accordance with section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, which sets out the procedures that an auditor should follow when he subsequently discovers facts which may have affected the audited financial statements previously reported on.

[Issue Date: September, 1986.]

AU Section 9317***Illegal Acts By Clients:
Auditing Interpretations
of AU Section 317*****1. Scope of Study and Evaluation of Accounting Control and the Foreign Corrupt Practices Act**

.01 Question—The second standard of field work requires the auditor to perform “a proper study and evaluation of the existing internal control.” The purpose of that study and evaluation is to establish a basis for the auditor’s reliance thereon in determining the nature, extent, and timing of audit tests to be applied in his examination of the financial statements. Section 323 (see Appendix G), which interprets the second standard of field work, states that “there is no requirement under generally accepted auditing standards to evaluate each control or to identify every material weakness.” Is the auditor of an entity subject to the Securities Exchange Act of 1934 now required, because of the enactment of the *Foreign Corrupt Practices Act of 1977* and the provisions of section 328 (see Appendix G), to expand the scope of his study and evaluation of internal control beyond that which is required by the second standard of field work?

.02 Interpretation—No. Section 328 (see Appendix G) indicates that the auditor should be aware that some client acts coming to his attention in the performance of his examination might be illegal. It does not require the auditor to plan his examination specifically to search for illegal acts. Furthermore, there is nothing in the Act or the related legislative history that purports to alter the auditor’s duty to his client or the purpose of his study and evaluation of internal accounting control. The Act creates express new duties only for companies subject to the Securities Exchange Act of 1934, not for auditors.

[Issue Date: October, 1978.]

2. Material Weaknesses in Accounting Control and the Foreign Corrupt Practices Act

.03 Question—What course of action should be followed by the auditor of an entity subject to the internal accounting control provision of the *Foreign Corrupt Practices Act of 1977* to comply with section 328 (see Appendix G) when a material weakness in internal accounting control comes to his attention?

.04 Interpretation—The standards applied by an auditor in determining a material weakness in internal accounting control may differ from the standards for determining a violation of the Act. Nevertheless, a specific material weakness may ultimately be determined to be a violation and, hence, an illegal act. Therefore, the auditor should inquire of the client’s management and consult with the client’s legal counsel as to whether the material weakness is a violation of the Act.

.05 In consultation with management and legal counsel, consideration should be given to corrective action taken or in process. If management has concluded that corrective action for a material weakness is not practicable, consideration should be given to the reasons underlying that conclusion, including management's evaluation of the costs of correction in relation to the expected benefit to be derived.¹ If it is determined that there has been a violation of the Act and appropriate consideration is not given to the violation, the auditor should consider withdrawing from the current engagement or dissociating himself from any future relationship with the client (see section 328.18—.19 in Appendix G).

.06 A violation of the internal accounting control provision of the Act would not, in and of itself, have a direct effect on amounts presented in audited financial statements. However, the contingent monetary effect on an entity ultimately determined to have willfully violated the internal accounting control provision of the Act could be fines of up to \$10,000 for the violation. The auditor should consider the materiality of such contingent monetary effect in relation to the audited financial statements taken as a whole. Other loss contingencies, as defined by FASB Statement No. 5 [AC section C59], ordinarily would not result from a weakness in the internal accounting control which gives rise to such a violation of the Act.

[Issue Date: October, 1978.]

[The next page is 1863-3.]

¹ The legislative history of the Act indicates that cost-benefit considerations are appropriate in determining compliance with the accounting provisions of the Act. For example, the Senate committee report stated that "the size of the business, diversity of operations, degree of centralization of financial and operating management, amount of contact by top management with day-to-day operations, and numerous other circumstances are factors which management must consider in establishing and maintaining an internal accounting control system."

AU Section 9324***Special-Purpose Reports on Internal Accounting Control at Service Organizations: Auditing Interpretations of AU Section 324*****1. Definition of a Service Organization**

.01 *Question*—Section 324, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, provides guidance on the auditor's use of a report on internal accounting control of an organization ("service organization") that provides certain accounting-related services to his client ("user organization"). When is an organization that provides accounting-related services to another organization considered by section 324 to be a service organization?

.02 *Interpretation*—For the purposes of section 324, an organization is considered to be a service organization if it provides either, or both, of the following services:

- ☐ Executing transactions as an agent or in a fiduciary capacity for another entity and maintaining the related accountability.
- ☐ Recording transactions executed entirely by the user organization and processing the related data.

.03 Examples of service organizations that provide the above services are: bank trust departments that invest and hold assets for others such as trustee employee benefit plans, EDP service centers that process transactions and related data for others, insurers that maintain the accounting for ceded reinsurance, mortgage bankers or savings and loan associations that service loans for others, and shareholder accounting organizations for investment companies. An auditor whose client uses a service organization should follow the guidance in section 324.

.04 An organization that provides accounting-related services is not considered to be a service organization if it has a direct interest in the transaction, i. e. the transaction directly affects the financial statements of the organization providing the service and, thus, is that organization's own transaction. Examples include transactions recorded in the accounts of an investee company, joint venture (e. g.,

oil and gas operator) or partnership whose investment is accounted for following the equity or proportionate consolidation methods by the investor client. In such a situation, the auditor of the organization using the accounting-related service ordinarily may be able to obtain sufficient evidential matter regarding the transactions by, for example, confirmation; obtaining audited financial statements of the investee, joint venture, or partnership; a report on the results of applying agreed-upon procedures to specified elements, accounts, or items of a financial statement; or other procedures.

.05 Although section 324 does not apply in situations that do not involve service organizations as defined here, the auditor of the entity using the service may nevertheless find the guidance in section 324 useful. For example, in considering the extent of reliance, if any, to be placed on internal control the auditor may find it more efficient or practical to consider the internal controls at the organization providing the accounting-related services. In those circumstances obtaining a report similar to a service auditor's report on procedures and controls at the other organization may be the most efficient approach.

[Issue Date: August, 1985.]

AU Section 9326***Evidential Matter: Auditing
Interpretations of
AU Section 326*****1. Evidential Matter for an Audit of Interim Financial Statements**

.01 *Question*—APB Opinion No. 28 [AC section I73] concluded that certain accounting principles and practices followed for annual reporting purposes may require modification at interim reporting dates. Paragraph 10 of Opinion No. 28 [AC section I73.103] states that the modifications are needed “so that the reported results for the interim period may better relate to the results of operations for the annual period.” The modifications introduce a need for estimates to a greater extent than is necessary for annual financial information. Does this imply a relaxation of the third standard of field work, which requires that sufficient competent evidential matter be obtained to afford a reasonable basis for an opinion regarding the financial statements under examination?

.02 *Response*—No. The third standard of field work applies to all engagements leading to an expression of opinion on financial statements or financial information.

.03 The objective of the independent auditor’s engagement is to obtain sufficient competent evidential matter to provide him with a reasonable basis for forming an opinion. The auditor develops specific audit objectives in light of assertions by management that are embodied in financial statement components. Section 326.11 states, “In selecting particular substantive tests to achieve the audit objectives he has developed, an auditor considers, among other things, the extent of reliance, if any, to be placed on internal accounting control, the relative risk of errors or irregularities that would be material to financial statements, and the expected effectiveness and efficiency of such tests. His considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved.”

.04 Evidential matter obtained for an audit of annual financial statements may also be useful in an audit of interim financial statements, and evidential matter obtained for an audit of interim financial statements may also be useful in an audit of annual financial state-

ments. Section 313.02 indicates that "Audit testing at interim dates may permit early consideration of significant matters affecting the year-end financial statements (for example, related party transactions, changed conditions, recent accounting pronouncements, and financial statement items likely to require adjustment)" and that "much of the audit planning, the study and evaluation of internal accounting control, and the application of substantive tests to transactions can be conducted prior to the balance-sheet date".¹ [As amended August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 313.)

.05 The introduction by Opinion No. 28 [AC section I73] of a need for additional estimates in measuring certain items for interim financial information may lead to a need for evidence in examining those items that differs from the evidence required in an examination of annual financial information. For example, computing the provision for federal income taxes in interim information involves estimating the effective tax rate expected to be applicable for the full fiscal year, and the auditor should examine evidence as to the basis for estimating that rate. Since the effective tax rate for the full year ordinarily is known at yearend, similar evidence is not usually required in examining annual information.

[Issue Date: February, 1974; modified: October, 1980.]

2. The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals

.06 *Question*—The Internal Revenue Service's audit manual instructs its examiners on how to secure from corporate officials "tax accrual workpapers" or the "tax liability contingency analysis," including, "a memorandum discussing items reflected in the financial statements as income or expense where the ultimate tax treatment is unclear." The audit manual states that the examiner may question or summons a corporate officer or manager concerning the "knowledge of the items that make up the corporation's contingent reserve accounts." It also states that "access may be had to the audit and tax workpapers of an independent accountant or an accounting firm" after attempting to obtain the information from the taxpayer. (Internal Revenue Manual, sections 4024.2-3, 6/12/80).

.07 Concern over IRS access to tax accrual working papers might cause some clients to not prepare or maintain appropriate documen-

¹See section 313, "*Substantive Tests Prior to the Balance-Sheet Date*" for guidance on the auditor's considerations before applying substantive tests to the details of asset or liability accounts at interim dates, including the relationship between internal accounting control and such tests, and on extending the audit conclusions from such tests to the balance-sheet date. [Footnote added August, 1983, by issuance of Statement on Auditing Standards No. 45.]

tation of the calculation or contents of the accrual for income taxes included in the financial statements, or to deny the independent auditor access to such information.

.08 What effect does this situation have on the auditor's opinion on the financial statements?

.09 *Interpretation*—Limitations on the auditor's access to information he considers necessary to audit the tax accrual will affect his ability to issue an unqualified opinion on the financial statements. Thus, if the client does not have appropriate documentation of the calculation or contents of the accrual for income taxes and denies the auditor access to client personnel responsible for making the judgments and estimates relating to the accrual, the auditor should assess the importance of that inadequacy in the accounting records and the client imposed limitation on his ability to form an opinion on the financial statements. Also, if the client has appropriate documentation but denies the auditor access to it and to client personnel who possess the information the auditor should assess the importance of the client-imposed scope limitation on his ability to form an opinion.

.10 The third standard of field work requires the auditor to obtain sufficient competent evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Section 326.23, "Evidential Matter", requires the auditor to obtain sufficient competent evidential matter about assertions in the financial statements of material significance or else to qualify or disclaim his opinion on the statements. Section 509.12, "Reports on Audited Financial Statements," states that, "When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on the financial statements." Also, section 333 on "Client Representations" requires the auditor to obtain written representations from management. Section 333.04 states that the representations ordinarily include, among other matters, "availability of all financial records and related data," and section 333.05 states that a materiality limit does not apply to that representation. Section 333.11 states that "management's refusal to furnish a written representation that the auditor believes is essential" constitutes a scope limitation. [Reference number 326.23, formerly 326.22, changed by the issuance of Statement on Auditing Standards No. 48.]

.11 *Question*—A client may allow the auditor to inspect its tax accrual workpapers, but may request that he not retain copies for his audit working papers, particularly of the tax liability contingency analysis. The client may also suggest that the auditor not prepare and

maintain similar documentation of his own. What should the auditor consider in deciding his response to such a request?

.12 Interpretation—Section 326.16 on “Evidential Matter” states that corroborating information includes information obtained by the auditor from inquiry, observation and inspection. Section 339 gives guidance on “Working Papers,” and states that they provide the principal record of conclusions the auditor has reached concerning significant matters and that ordinarily they should include, among other things, documentation showing that the audit evidence obtained afforded a reasonable basis for an opinion. The section also states that working papers may take the form of memoranda. The nature and extent of audit working paper documentation that is necessary to meet those requirements is a matter of the auditor’s professional judgment in light of the circumstances and his needs on the specific engagement. [As modified by the issuance of Statement on Auditing Standards No. 41.] (See section 339.) [Reference number 326.16, formerly 326.15, changed by the issuance of Statement on Auditing Standards No. 48.]

.13 Question—In some situations a client may furnish its outside legal counsel or in-house legal or tax counsel with information concerning the tax contingencies covered by the accrual for income taxes included in the financial statements and ask counsel to give the auditor an opinion on the adequacy of the accrual for those contingencies.

.14 In such circumstances, instead of inspecting the client’s tax liability contingency analysis and making inquiries of the client, may the auditor consider the counsel as a specialist within the meaning of section 336, “Using the Work of a Specialist,” and rely solely on counsel’s opinion as an appropriate procedure for obtaining evidential matter to support his opinion on the financial statements?

.15 Interpretation—No. The opinion of legal counsel in this situation would not provide sufficient competent evidential matter to afford a reasonable basis for an opinion on the financial statements.

.16 Section 336.01 defines a specialist as “a person or firm possessing special skill or knowledge in a particular field other than accounting or auditing.” It is intended to apply to situations requiring special knowledge of matters about which the auditor does not have adequate technical training and proficiency. The auditor’s education, training and experience on the other hand, do enable him to be knowledgeable concerning income tax matters and competent to assess their presentation in the financial statements.

.17 The opinion of legal counsel on specific tax issues that he is asked to address and to which he has devoted substantive attention, as contemplated by section 337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," can be useful to the auditor in forming his own opinion. However, the audit of income tax accounts requires a combination of tax expertise and the knowledge about the client's business that is accumulated during all aspects of an audit. Therefore, as stated above, it is not appropriate for the auditor to rely solely on such legal opinion.

[Issue Date: March, 1981.]

3. The Auditor's Consideration of the Completeness Assertion

.18 *Question*—Section 326, *Evidential Matter*, paragraph .03, identifies five categories of assertions that are embodied in financial statement components. In obtaining audit evidence about four of these categories—existence or occurrence, rights and obligations, valuation or allocation, and presentation and disclosure—the auditor considers transactions and accounts that are included in the financial statements. In contrast, in obtaining audit evidence about the completeness assertion, the auditor considers whether transactions and accounts have been improperly excluded from the financial statements. May management's written representations and the auditor's reliance on internal accounting controls constitute sufficient audit evidence about the completeness assertion?

.19 *Interpretation*—Written representations from management are a part of the evidential matter the auditor obtains in an examination in accordance with generally accepted auditing standards. Management's representations about the completeness assertion, whether considered alone or in combination with the auditor's reliance on internal accounting controls, do not constitute sufficient audit evidence to support that assertion. Obtaining such representations complements but does not replace other auditing procedures that the auditor should perform.

.20 In planning audit procedures to obtain evidence about the completeness assertion, the auditor should consider the inherent risk that transactions and accounts have been improperly omitted from the financial statements. When the auditor assesses the inherent risk of omission for a particular account balance or class of transactions to be such that he believes omissions could exist that might be material when aggregated with errors in other balances or classes, he should restrict the audit risk of omission by performing substantive tests designed to obtain evidence about the completeness assertion. Substantive tests designed primarily to obtain evidence about the

completeness assertion include analytical review procedures and tests of details of *related populations*.¹

.21 The auditor's reliance on substantive tests of completeness may properly vary inversely with any reliance he places on internal accounting controls designed to provide reasonable assurance that all transactions and accounts that should be presented in the financial statements are so included. Because of the unique nature of the completeness assertion, reliance on internal accounting controls may be an effective means for the auditor to obtain evidence about that assertion. Although reliance on internal accounting controls is not required to satisfy the auditor's objectives with respect to the completeness assertion, the auditor should consider that for some transactions (e. g., revenues that are received primarily in cash, such as those of a casino or of some charitable organizations) it may be difficult to limit audit risk to an acceptable level without some reliance on internal accounting controls.

[Issue Date: April, 1986.]

➡ *The next page is 1871.* ←

¹For purposes of this interpretation, a related population is a population other than the recorded account balance or class of transactions being audited that would be expected to contain evidence of whether all accounts or transactions that should be presented in that balance or class are so included.

AU Section 9329***Analytical Procedures: Auditing
Interpretations of AU Section 329*****1. Corroboration of Replies to Inquiries in Applying Analytical Review Procedures**

.01 Question—Section 318.08 (see Appendix G) states that when investigating significant fluctuations¹ identified by analytical review procedures, the auditor would “consider the need to corroborate the replies to his inquiries by the application of other auditing procedures.” Does this modify the general guidance in section 333.02, that “representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for his opinion on the financial statements?”

.02 Interpretation—No. Section 318.08 (see Appendix G) provides that the auditor will “evaluate the reasonableness of replies to his inquiries by reference to his knowledge of the business and other information already obtained during the conduct of the examination.” Thus, the auditor’s decision whether to accept management’s explanation of a significant fluctuation without applying additional auditing procedures is determined by his evaluation of the sufficiency of relevant evidential matter already obtained.

[Issue Date: March, 1979.]

[The next page is 1895.]

¹ Section 318 (see Appendix G) defines significant fluctuations as fluctuations that are not expected, the absence of fluctuations when they are expected, and other items that appear to be unusual that are identified by analytical review procedures and that the auditor believes are indicative of matters that have a significant effect on his examination.

AU Section 9331***Receivables and Inventories:
Auditing Interpretations
of AU Section 331*****1. Evidential Matter for Inventories at Interim Dates**

.01 Question—Paragraph 14 of APB Opinion No. 28 [AC section 173.107] states that “companies should generally use the same inventory pricing methods and make provisions for writedowns to market at interim dates on the same basis as used at annual inventory dates,” and further states that there are four exceptions that are appropriate at interim reporting dates, including the use of estimated gross profit rates to determine the cost of goods sold for interim periods. What effect does the use of such estimates have on the auditor’s examination of inventories for the interim period?

.02 Response—The auditor’s objective in examining evidence as to the amounts shown for cost of goods sold and inventories in interim information should be to satisfy himself that the client’s estimate produces results that are substantially the same as those that would be obtained by following yearend procedures. Examining such evidence may not provide the auditor with sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements under examination.

.03 Performing procedures with respect to the reasonableness of estimates used to determine cost of goods sold and inventories is not unlike performing procedures for an annual audit when inventory is not counted at the yearend date (see sections 313 and 331.09, .10 and .13). The considerations that influence the auditor in deciding whether the procedures performed provide him with sufficient competent evidential matter for interim financial information are similar to those for annual financial information. Section 326.11 states, “In selecting particular substantive tests to achieve the audit objectives he has developed, an auditor considers, among other things, the extent of reliance, if any, to be placed on internal accounting control, the relative risk of errors or irregularities that would be material to financial statements, and the expected effectiveness and efficiency of such tests. His considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved.” [Reference changed to section 313 August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 313.)

.04 The auditor's decision as to the sufficiency and competence of the evidence available to support the amounts reported for cost of goods sold and for inventories will be influenced by many factors, among which are

1. The length of time that has elapsed since the most recent physical count.
2. The auditor's past experience with the client.
3. The auditor's knowledge of the nature of the client's business and the current business conditions.
4. The materiality of possible misstatement.
5. The nature and condition of the client's accounting records and system.
6. The existence of records that provide information as to inventory changes, such as shipments made, scrap, waste, obsolescence and shrinkage.

.05 The auditor ordinarily has more evidence available to evaluate the validity of estimates when the client's accounting system provides information as to changes in inventory. If the client's accounting records reflect the allocation and classification of transactions with persons outside the company but not inventory changes, the auditor is not likely to have the necessary evidence to support estimates of costs of goods sold and inventories. In either case the auditor must evaluate all relevant factors in deciding whether there is sufficient competent evidential matter.

[Issue Date: February, 1974; modified: October, 1980.]

AU Section 9332**Long-Term Investments:
Auditing Interpretations
of AU Section 332****1. Evidential Matter for the Carrying Amount of Marketable Securities ***

.01 *Question*—Section 332.03, states: “With respect to the carrying amount of [long-term] investments, a loss in value which is other than a temporary decline should be recognized in the financial statements of an investor.” ARB No. 43, chapter 3A, *Current Assets and Current Liabilities*, paragraph 9, with respect to working capital and current assets, states: “In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value.” What evidence should the auditor obtain pertaining to the classification and the carrying amount of marketable securities when market value is below cost?

.02 *Interpretation*—Section 509.21 (see Appendix G) states: “In preparing financial statements, management is expected to use its estimates of the outcome of future events.” Estimates of the outcome of future events include determining the proper carrying amount for securities when market value is below cost. The auditor should examine evidence to determine whether management properly classified the marketable securities as current or noncurrent assets and whether the amounts at which they are carried in the financial statements are appropriate. The auditor should evaluate the reasons for the market decline when market value is below cost.

.03 Declines in market value may be temporary in nature or may reflect conditions that are more persistent. The distinction between temporary and persistent, however, has been largely undefined. Declines may result primarily from daily market fluctuations or from short-term variations in general economic or market conditions that are temporary in nature. Declines may also be attributable to general economic and money market conditions that persist for other than a temporary time period. Other market declines may be attributable to specific adverse conditions that affect a particular company's securities.

.04 *Classification of Securities*—The classification of marketable securities as either current assets or noncurrent assets is an important

* See also FASB Statement No. 12 [AC section I89].

consideration in evaluating their proper carrying amounts. Whether marketable securities are properly classified depends to a large extent on management's intent. If management intends to dispose of the securities in the next fiscal year, the securities are classified as a current asset. Marketable securities that represent an excess of funds available for operations, but which management does not intend to dispose of, are often classified as current assets since management can sell them at any time at their option.

.05 The auditor should ascertain management's investment objectives to determine whether the securities are properly classified in the financial statements. He should read the minutes of the board of directors meetings, and he should inquire of the investment committee concerning management's intentions on disposing of the securities. To corroborate management's representation as to its intent, the auditor should consider whether such classification is feasible in light of the company's financial position, working capital requirements, debt agreements, and any other contractual obligations. The client's needs may be such that it is reasonable to presume that the securities will need to be sold to raise operating capital, and consequently should be classified as current assets.

.06 The auditor should obtain management's representation as to their intent in the client's representation letter. In some circumstances, the classification in the balance sheet should be supplemented by additional information in the notes to the financial statements regarding management's intent to make the financial statements more meaningful to users. The auditor should evaluate the adequacy of disclosures concerning classification of investments in securities and consider the need for such disclosures.

.07 *Investments Classified as Current Assets.* Marketable securities, such as stocks and bonds, properly classified as current assets should be written down to market at the balance sheet date to reflect declines that are not temporary in accordance with ARB No. 43, chapter 3A, paragraph 9. When marketable securities classified as a current asset have a market value lower than cost, retention of the cost basis requires persuasive evidence that indicates a recovery in the market value will occur before the earlier of the scheduled maturity or sale date of the securities or within a one-year period from the balance sheet date. Generally, such evidence would be limited to substantial recovery subsequent to the year end. When such evidence does not exist and the client's management carries those securities at cost, the auditor will normally conclude that he does not agree with management's determination of the carrying amount of the securities. Section 509.21 (see Appendix G) states: "If the auditor, on the basis of evidence available to him, disagrees with management's determination, and if the effects on the financial statements are material, he should express

a qualified or an adverse opinion because of a departure from generally accepted accounting principles.”

.08 *Investments Classified as Noncurrent Assets.* Investments in marketable securities that are properly classified as noncurrent assets should be carried at amounts that result in a fair presentation in conformity with generally accepted accounting principles. If there has been a decline in the market value of those investments, the auditor should obtain evidence concerning the nature of the decline. In making that determination, he should consider the ability to ultimately recover the carrying amount of the investments.

.09 When the market decline is attributable to specific adverse conditions for a particular security, stocks or bonds, a write down in carrying amount is necessary unless persuasive evidence exists to support the carrying amount.

.10 The value of investments in marketable securities classified as noncurrent assets may decline because of general market conditions that reflect prospects of the economy as a whole or prospects of a particular industry. Such declines may or may not be indicative of the ability to ultimately recover the carrying amount of investments. The auditor should consider all available evidence to evaluate the carrying amount of the securities. For investments in bonds and other investments with fixed maturity amounts, market declines may be considered temporary unless the evidence indicates that such investments will be disposed of before they mature or that they may not be realizable.

.11 If the auditor concludes the available information does not support either a judgment as to eventual recovery or a contrary judgment that recovery will not occur, the continued existence of a decline in market value is indicative of an uncertainty, as described in section 509.22. “In certain instances, the outcome of matters that may affect the financial statements or the disclosures required therein is not susceptible of reasonable estimation; such matters are to be regarded as uncertainties. . . . When such uncertainties exist, it cannot be determined whether the financial statements should be adjusted, or in what amount.” The auditor should appropriately qualify his opinion because of the uncertainty of recovering the carrying amount of the asset. A qualification based on the uncertainty of recoverability, however, is not a substitute for recognition of a loss when such recognition is appropriate.

.12 *Reclassifications of Investments.* Management may classify as a noncurrent asset a security that was classified in the previous year’s financial statements as a current asset. Such a change in classification does not require the auditor to qualify his opinion as to consistency if it results from additional experience and information acquired in the

current year (see section 420.12). For example, management may conclude that the decline in market value will eventually be recovered and decide not to dispose of the security until its market value recovers. If the change in classification is material, the auditor should evaluate the adequacy of disclosure explaining the change (see section 420.14).

.13 *Unclassified Balance Sheets.* Companies in some industries, such as insurance, investment, finance, and real estate do not present classified balance sheets. The representations made by management in an unclassified balance sheet differ from those made in a classified balance sheet. For example, inclusion of an asset in the current assets section of a classified balance sheet implies that those assets will be, or can be, converted into cash in a specified period. Therefore, if the amount to be realized from converting those assets appears to be impaired, generally accepted accounting principles require that they should be written down to their market values. In an unclassified balance sheet, no representations are made about working capital as of the balance sheet date.

.14 If securities are carried at cost in an unclassified balance sheet, the auditor should consider the operational needs of the company for the foreseeable future. For those securities that will be disposed of in the foreseeable future the auditing considerations are similar to those for marketable securities classified as current assets. For those securities for which there is no evidence indicating that they will be disposed of in the foreseeable future to meet the company's operational needs, the auditing considerations are similar to those discussed for marketable securities classified as noncurrent assets.

[Issue Date: January, 1975.]

AU Section 9333***Client Representations:
Auditing Interpretations
of AU Section 333*****1. Management Representations on Violations and Possible Violations of Laws and Regulations**

.01 *Question*—Section 333, *Client Representations*, lists matters for which the auditor ordinarily obtains written representations from management. One of those matters is: Violations or possible violations of laws or regulations whose effects should be considered for disclosure in financial statements or as a basis for recording a loss contingency.

.02 Guidance on evaluating the need to disclose litigation, claims, and assessments that may result from possible violations is provided by FASB Statement No. 5 [AC section C59], *Accounting for Contingencies*. Section 328, *Illegal Acts by Clients* (see Appendix G), provides guidance on evaluating the materiality of illegal acts. Does the representation regarding “possible violations” include matters beyond those described in FASB Statement No. 5 [AC section C59] and section 328 (see Appendix G)?

.03 *Interpretation*—No. Section 333 did not change the relevant criteria for evaluating the need for disclosure of violations and possible violations of laws or regulations. In requesting the representation on possible violations, the auditor is not asking for management’s speculation on all possibilities of legal challenges to its actions.

.04 The representation concerns matters that have come to management’s attention and that are significant enough that they should be considered in determining whether financial statement disclosures are necessary. It recognizes that these are matters of judgment and that the need for disclosure is not always readily apparent.

[Issue Date: March, 1979.]

[The next page is 1903.]

AU Section 9334*

Related Parties: Auditing Interpretations of AU Section 334

[1.] Evaluating the Adequacy of Disclosure of Related Party Transactions

[.01—.05] [Withdrawn August, 1983, by SAS No. 45.] (See section 334.)

[2.] Disclosure of Commonly Controlled Parties

[.06—.09] [Withdrawn August, 1983, by SAS No. 45.] (See section 334.)

[3.] Definition of "Immediate Family"

[.10—.11] [Withdrawn August, 1983, by SAS No. 45.] (See section 334.)

4. Exchange of Information Between the Principal and Other Auditor on Related Parties

.12 *Question*—Section 334, *Related Parties*, paragraphs .04 and .07, states that "during the course of his examination, the auditor should be aware of the possible existence of material related party transactions," and that determining the existence of related party transactions may require the inquiry of the "principal, or other auditors of related entities as to their knowledge of existing relationships and the extent of management involvement in material transactions." When should that inquiry be made? [Reference changed August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 334.)

.13 *Interpretation*—The principal auditor and the other auditor should each obtain from the other the names of known related parties and the other information referred to above. Ordinarily, that exchange of information should be made at an early stage of the examination.

[Issue Date: April, 1979.]

5. Examination of Identified Related Party Transactions with a Component

.14 *Question*—According to section 334.09, once related party transactions have been identified, "the auditor should apply the procedures he considers necessary to obtain satisfaction concerning the pur-

* [Section number changed August, 1983, to correspond to section 334, *Related Parties*.]

pose, nature and extent of these transactions and their effect on the financial statements." When there is a principal auditor-other auditor relationship, how may the auditors obtain that satisfaction regarding transactions that may involve not only the components¹ they are examining, but also, other components? [Reference changed August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 334.)

.15 *Interpretation*—Audit procedures may sometimes have to be applied to records of components being examined by the other. One auditor may arrange to perform those procedures himself, or he may request the other to do so.² There may be circumstances when there are unusual or complex related party transactions and an auditor believes that access to relevant portions of the other's work papers is essential to his understanding of the effects of those transactions on the financial statements he is examining. In those circumstances, access ordinarily should be provided.³

[Issue Date: April, 1979.]

6. The Nature and Extent of Auditing Procedures for Examining Related Party Transactions

.16 *Question*—Section 334, *Related Parties*, provides general guidance about the types of procedures an auditor might apply to identified related party transactions. How extensive should the auditor's procedures be to examine related party transactions?

.17 *Interpretation*—The auditor's procedures should be sufficient to provide reasonable assurance that related party transactions are adequately disclosed and that identified related party transactions do not contain errors that, when aggregated with errors in other balances or classes of transactions, could be material to the financial statements taken as a whole. As in examining any other material account balance or class of transactions, the auditor needs to consider audit risk⁴ and design and apply appropriate substantive tests to evaluate management's assertions.

.18 The risk associated with management's assertions about related party transactions is often assessed as higher than for many

¹ For the purpose of this interpretation, the entities whose separate financial statements collectively comprise the consolidated or other financial statements are referred to as components.

² In this case, the auditor should follow the guidance in the interpretation titled *Specific Procedures Performed by Other Auditors at the Principal Auditor's Request*, section 9543.01—.03.

³ There is no intention in this interpretation to modify section 543.12c regarding the principal auditor's consideration of review of the other auditor's workpapers when he decides not to make reference to the other auditor.

⁴ Audit risk and its components are described in section 312, *Audit Risk and Materiality in Conducting an Audit*.

other types of transactions because of the possibility that the parties to the transaction are motivated by reasons other than those that exist for most business transactions.⁵

.19 The higher the auditor's assessment of risk regarding related party transactions, the more extensive or effective the audit tests should be. For example, the auditor's tests regarding valuation of a receivable from an entity under common control might be more extensive than for a trade receivable of the same size because the common parent may be motivated to obscure the substance of the transaction. In assessing the risk of the related party transactions the auditor obtains an understanding of the business purpose of the transactions. Until the auditor understands the business sense of material transactions, he cannot complete his examination. If he lacks sufficient specialized knowledge to obtain that understanding for a particular transaction, he should consult with persons who do have the requisite knowledge. In addition, to understand the transaction, or obtain evidence regarding it, the auditor may have to refer to audited or unaudited financial statements of the related party, apply procedures at the related party, or in some cases audit the financial statements of the related party.

.20 *Question*—Section 334, *Related Parties*, paragraph .07, states that specific audit procedures should be applied to determine if related parties exist. That paragraph also suggests some specific audit procedures to identify related parties that the auditor should consider. What other audit procedures for determining the existence of related parties should the auditor consider?

.21 *Interpretation*—The auditor should consider obtaining representations from the entity's senior management and its board of directors about whether they or any other related parties engaged in any transactions with the entity during the period.

[Issue Date: May, 1986.]

➡ The next page is 1903-5. ⬅

⁵ See section 334.06.

AU Section 9336***Using the Work of a Specialist:
Auditing Interpretations of
AU Section 336*****1. Applicability of Guidance on the Use of Specialists**

.01 *Question*—Management may engage or employ a specialist to prepare, or assist in the preparation of, amounts or disclosures in the financial statements. If that amount or disclosure is material to the financial statements, is the guidance in section 336, *Using the Work of a Specialist*, applicable when making an examination of the financial statements in accordance with generally accepted auditing standards?

.02 *Interpretation*—Yes. Section 336 states, “During his examination . . . an auditor may encounter matters potentially material to the fair presentation of financial statements in conformity with generally accepted accounting principles that require special knowledge and that in his judgment require using the work of a specialist.” When a specialist has prepared, or assisted in the preparation of, a matter that is potentially material to the financial statements, if the auditor intends to use that specialist’s work as evidential matter, he should follow the guidance in section 336.

.03 Thus, as with any specialist whose work the auditor uses, the auditor should satisfy himself as to the professional qualifications and reputation of the specialist, obtain an understanding of the specialist’s methods and assumptions, test accounting data provided to the specialist, and consider whether the specialist’s findings support the related representations in the financial statements.

[Issue Date: October, 1979.]

2. Exclusion of Specialists on the Audit Staff

.04 *Question*—Section 336, *Using the Work of a Specialist*, in footnote 1 states, “This statement does not apply to using the work of a specialist who is a member of the auditor’s staff. . . .” Does this mean that section 336 does not apply when a specialist with an auditor’s firm provides advisory services to a client?

.05 *Interpretation*—No. The exclusion in section 336 only relates to specialists serving as members of the audit staff, that is, those who participate in the audit. For example, statisticians may assist in the execution of audit sampling plans or computer specialists may assist

in the examination of financial statements of clients with complex EDP operations. However, some CPA firms have specialists who provide advisory services in addition to participating in an audit. The exclusion applies only to a specialist's participation in the audit. When a specialist with the auditor's firm provides advisory services to a client and the auditor decides to use that specialist's work as evidential matter, he should follow the guidance in section 336.

[Issue Date: October, 1979.]

AU Section 9337***Inquiry of a Client's Lawyer Concerning
Litigation, Claims, and Assessments:
Auditing Interpretations of
AU Section 337*****1. Specifying Relevant Dates in an Audit Inquiry Letter**

.01 *Question*—Should the auditor request the client to specify, in his audit inquiry letter to a lawyer prepared in accordance with section 337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," the date by which the lawyer's response should be sent to the auditor? Also, should the letter request the lawyer to specify in his response the latest date covered by his review (the "effective date")?

.02 *Interpretation*—Yes. It should be recognized that, to adequately respond to an audit inquiry letter, lawyers will ordinarily employ some internal review procedures which will be facilitated by specifying the earliest acceptable effective date of the response and the latest date by which it should be sent to the auditor. Ordinarily, a two-week period should be allowed between the specified effective date of the lawyer's response and the latest date by which the response should be sent to the auditor. Clearly stating the relevant dates in the letter and specifying these dates to the lawyer in a timely manner will allow the responding lawyer an adequate amount of time to complete his review procedures and assist the auditor in coordinating the timing of the completion of his field work with the latest date covered by the lawyer's review.

.03 Further, the lawyer should be requested to specify the effective date of his response. If the lawyer's response does not specify an effective date, the auditor can assume that the date of the lawyer's response is the effective date.

[Issue Date: March, 1977.]

2. Relationship Between Date of Lawyer's Response and Auditor's Report

.04 *Question*—The illustrative form of audit inquiry letter included in the Appendix to section 337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," requests a response as to matters that existed at the balance sheet date and during the

period from that date to the date of the response. What is the relationship between the effective date of the lawyer's response and the date of the auditor's report, which is generally the date of the completion of field work?

.05 Interpretation—Section 560.10-12 indicates that the auditor is concerned with events, which may require adjustment to, or disclosure in, the financial statements, occurring through the date of his report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the completion of field work as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the completion of the field work will in most instances obviate the need for an updated response from the lawyer.

[Issue Date: March, 1977.]

3. Form of Audit Inquiry Letter when Client Represents that No Unasserted Claims and Assessments Exist

.06 Question—The illustrative audit inquiry letter included in the Appendix to section 337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," assumes that the client specifies certain unasserted claims and assessments. However, in some cases, clients have stated that there are no such claims or assessments (to be specified to the lawyer for comment) that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome. What appropriate revision to the wording of the letter can be used in such situations?

.07 Interpretation—Wording that could be used in an audit inquiry letter, instead of the heading and first paragraph in the section relating to unasserted claims and assessments included in the Appendix to section 337, when the client believes that there are no unasserted claims or assessments (to be specified to the lawyer for comment) that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome as specified by FASB Statement of Financial Accounting Standards No. 5 [AC section C59], "Accounting for Contingencies," is as follows:

Unasserted claims and assessments—We have represented to our auditors that there are no unasserted possible claims that you have advised us are probable of assertion and must be disclosed, in accordance with Statement of Financial Accounting Standards No. 5. (The second paragraph in the section relating to unasserted claims and assessments would not be altered.)

[Issue Date: March, 1977.]

4. Documents Subject to Lawyer-Client Privilege

.08 *Question*—Section 337.05c states: "Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers." Would this include a review of documents at the client's location considered by the lawyer and the client to be subject to the lawyer-client privilege?

.09 *Interpretation*—No. Although ordinarily an auditor would consider the inability to review information that could have a significant bearing on his examination as a scope restriction, in recognition of the public interest in protecting the confidentiality of lawyer-client communications (see section 337.13), section 337.05c is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege. In the event of questions concerning the applicability of this privilege, the auditor may request confirmation from the client's counsel that the information is subject to that privilege and that the information was considered by the lawyer in responding to the audit inquiry letter or, if the matters are being handled by another lawyer, an identification of such lawyer for the purpose of sending him an audit inquiry letter.

[Issue Date: March, 1977.]

5. Alternative Wording of the Illustrative Audit Inquiry Letter to a Client's Lawyer

.10 *Question*—The appendix of section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, provides an illustrative audit inquiry letter to legal counsel. That inquiry letter is based on the assumptions that (1) management of the company has prepared and furnished to the auditor and has set forth in the audit inquiry letter a description and evaluation of pending or threatened litigation, claims, and assessments and (2) management has identified and specified for comment in the audit inquiry letter unasserted claims or assessments that are probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome. In many engagements, circumstances may render certain portions of the illustrative letter inappropriate. For instance, many clients ask their lawyers to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments rather than have management furnish such information. How can the wording of the inquiry letter be modified to recognize circumstances that differ from those assumed in the illustrative letter and to be more specific regarding the timing of the lawyer's response?

.11 *Interpretation*—Section 337.09, outlines the matters that should be covered in a letter of audit inquiry. Although section 337 provides

an illustrative audit inquiry letter to legal counsel, it should be modified, if necessary, to fit the circumstances. The modified illustrative audit inquiry letter that follows is based on a typical situation: management requests the lawyer to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments, and also represents that there are no unasserted claims or assessments that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome as specified by Statement of Financial Accounting Standards No. 5, [AC section C59] *Accounting for Contingencies*. It also includes a separate response section with language that clarifies the auditor's expectations regarding the timing of the lawyer's response.

"In connection with an examination of our financial statements as of (balance-sheet date) and for the (period) then ended, please furnish our auditors, (name and address of auditors), with the information requested below concerning certain contingencies involving matters with respect to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation." [When a materiality limit has been established based on an understanding between management and the auditor, the following sentence should be added: This request is limited to contingencies amounting to (amount) individually or items involving lesser amounts that exceed (amount) in the aggregate.]

.12 Pending or Threatened Litigation, Claims, and Assessments

"Regarding pending or threatened litigation, claims, and assessments, please include in your response: (1) the nature of each matter, (2) the progress of each matter to date, (3) how the Company is responding or intends to respond (for example, to contest the case vigorously or seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss."

.13 Unasserted Claims and Assessments

"We have represented to our auditors that there are no unasserted possible claims or assessments that you have advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59].¹ We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assess-

¹A parenthetical statement such as "(excerpts of which can be found in the ABA's *Auditor's Letter Handbook*)" might be added here if the auditor believes that it would be helpful to the lawyer's understanding of the requirements of FASB Statement No. 5 [AC section C59]. The *Auditor's Letter Handbook* contains, among other things, a copy of section 337 the ABA's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, and excerpts from FASB Statement No. 5 [AC section C59].

ment that may call for financial statement disclosure, you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5 [AC section C59]. Please specifically confirm to our auditors that our understanding is correct."

.14 Response

"Your response should include matters that existed as of (balance-sheet date) and during the period from that date to the effective date of your response."

"Please specifically identify the nature of and reasons for any limitations on your response."

"Our auditors expect to have the audit completed about (expected completion date). They would appreciate receiving your reply by that date with a specified effective date no earlier than (ordinarily two weeks before expected completion date)."²

[Issue Date: June 1983.]

6. Client Has Not Consulted a Lawyer

.15 Question—Section 337.06 requires an auditor to request that the client's management send a letter of inquiry to those lawyers with whom management has consulted concerning litigation, claims, or assessments. In some instances, management may not have consulted a lawyer. In such circumstances, what should the auditor do to obtain sufficient, competent evidential matter regarding litigation, claims, and assessments?

.16 Interpretation—Section 337 is expressly limited to inquiry of lawyers with whom management has consulted. If the client has not consulted a lawyer, the auditor normally would rely on the review of internally available information as outlined in section 337.05 and .07, and the written representation of management regarding litigation, claims, and assessments as required by section 333, *Client Representations*, paragraphs 4r and s. In those circumstances, the representation regarding litigation, claims, and assessments might be worded as follows:

"We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are

²Two auditing interpretations (see sections 9337.01—.05) address relevant dates in an audit inquiry letter and the relationship between the date of the lawyer's response and the audit report date. See JofA, Mar. 77, pp. 101-102. See also section 9337.01—.05.

required to be accrued or disclosed in the financial statements in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59], and we have not consulted a lawyer concerning litigation, claims, or assessments.”

.17 If information comes to the auditor's attention that may indicate potentially material litigation, claims, or assessments, the auditor should discuss with the client its possible need to consult legal counsel so that the client may evaluate its responsibility under FASB Statement No. 5 [AC section C59] to accrue or disclose loss contingencies. Depending on the severity of the matter, refusal by the client to consult legal counsel in those circumstances may result in a scope limitation, and the auditor should consider the effect of such a limitation on his audit report.

[Issue Date: June, 1983.]

7. Assessment of a Lawyer's Evaluation of the Outcome of Litigation

.18 *Question*—Section 337.09d(2), *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, states that a letter of audit inquiry should include a request for the lawyer's evaluation of the likelihood of an unfavorable outcome of pending or threatened litigation, claims, and assessments to which he has devoted substantive attention. However, written responses from lawyers vary considerably and may contain evaluation wording that is vague or ambiguous and, thus, of limited use to the auditor. What constitutes a clear response and what should the auditor do if he considers the response unclear?

.19 *Interpretation*—The American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (ABA Statement) is reprinted as Exhibit II to section 337. While paragraph 5 of the ABA Statement states that the lawyer “may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is ‘probable’ or ‘remote’,” he is not required to use those terms in communicating his evaluation to the auditor. The auditor may find other wording sufficiently clear as long as the terms can be used to classify the outcome of the uncertainty under one of the three probability classifications established in FASB Statement No. 5 [AC section C59], *Accounting for Contingencies*.³

³ FASB Statement No. 5 [AC section C59] uses the terms “probable,” “reasonably possible,” and “remote” to describe different degrees of likelihood that future events will confirm a loss or an impairment of an asset or incurrence of a liability, and the accounting standards for accrual and disclosure are based on those terms. (See the auditing interpretation, *Reporting on Loss Contingencies*, section 9509.11—.14 in Appendix G.)

.20 Some examples of evaluations concerning litigation that may be considered to provide sufficient clarity that the likelihood of an unfavorable outcome is "remote" even though they do not use that term are:

- ☐ "We are of the opinion that this action will not result in any liability to the company."
- ☐ "It is our opinion that the possible liability to the company in this proceeding is nominal in amount."
- ☐ "We believe the company will be able to defend this action successfully."
- ☐ "We believe that the plaintiff's case against the company is without merit."
- ☐ "Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the company in these suits."

.21 Absent any contradictory information obtained by the auditor either in other parts of the lawyer's letter or otherwise, the auditor need not obtain further clarification of evaluations such as the foregoing.

.22 Because of inherent uncertainties described in section 337.14 and in the ABA Policy Statement, an evaluation furnished by the lawyer may indicate significant uncertainties or stipulations as to whether the client will prevail. The following are examples of lawyers' evaluations that are unclear as to the likelihood of an unfavorable outcome:

- ☐ "This action involves unique characteristics wherein authoritative legal precedents do not seem to exist. We believe that the plaintiff will have serious problems establishing the company's liability under the act; nevertheless, if the plaintiff is successful, the award may be substantial."
- ☐ "It is our opinion that the company will be able to assert meritorious defenses to this action." (The term "meritorious defenses" indicates that the company's defenses will not be summarily dismissed by the court; it does not necessarily indicate counsel's opinion that the company will prevail.)
- ☐ "We believe the action can be settled for less than the damages claimed."
- ☐ "We are unable to express an opinion as to the merits of the litigation at this time. The company believes there is absolutely no merit to the litigation." (If client's counsel, with the benefit of all relevant information, is unable to conclude that the likelihood of an unfavorable outcome is "remote," it is

unlikely that management would be able to form a judgment to that effect.)

- ☐ "In our opinion, the company has a substantial chance of prevailing in this action." (A "substantial chance," a "reasonable opportunity," and similar terms indicate more uncertainty than an opinion that the company will prevail.)

.23 If the auditor is uncertain as to the meaning of the lawyer's evaluation, he should request clarification either in a follow-up letter or a conference with the lawyer and client, appropriately documented. If the lawyer is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor should consider the effect of the uncertainty on his opinion.

[Issue Date: June 1983.]

8. Use of the Client's Inside Counsel in the Evaluation of Litigation, Claims, and Assessments

.24 *Question*—Section 337.06 requires an auditor to request that the client's management send a letter of inquiry to those lawyers with whom management has consulted concerning litigation, claims, and assessments. Sometimes, the client's inside general counsel or legal department (hereafter referred to as "inside counsel") is handling litigation, claims, and assessments either exclusive of or in conjunction with outside lawyers. In such circumstances, when does inside counsel's response constitute sufficient, competent evidential matter regarding litigation, claims, and assessments?

.25 *Interpretation*—Section 337.08 states that "Evidential matter obtained from the client's inside general counsel or legal department may provide the auditor with the necessary corroboration." Inside counsel can range from one lawyer to a large staff, with responsibilities ranging from specific internal matters to a comprehensive coverage of all of the client's legal needs, including litigation with outside parties. Because both inside counsel and outside lawyers are bound by the ABA's Code of Professional Responsibilities, there is no difference in their professional obligations and responsibilities. In some circumstances, outside lawyers, if used at all, may be used only for limited purposes, such as data accumulation or account collection activity. In such circumstances, inside counsel has the primary responsibility for corporate legal matters and is in the best position to know and precisely describe the status of all litigation, claims, and assessments or to corroborate information furnished by management.

.26 Audit inquiry letters should be sent to those lawyers, which may be either inside counsel or outside lawyers, who have the primary responsibility for, and knowledge about, particular litigation,

claims, and assessments. If inside counsel is handling litigation, claims, and assessments exclusively, their evaluation and response ordinarily would be considered adequate. Similarly, if both inside counsel and outside lawyers have been involved in the matters, but inside counsel has assumed the primary responsibility for the matters, inside counsel's evaluation may well be considered adequate.⁴ However, there may be circumstances when litigation, claims, or assessments involving substantial overall participation by outside lawyers are of such significance to the financial statements that the auditor should consider obtaining the outside lawyers' response that they have not formulated a substantive conclusion that differs in any material respect from inside counsel's evaluation, even though inside counsel may have primary responsibility.

.27 If both inside counsel and outside lawyers have devoted substantive attention to a legal matter, but their evaluations of the possible outcome differ, the auditor should discuss the differences with the parties involved. Failure to reach agreement between the lawyers may require the auditor to consider appropriate modification of his audit report.

[Issue Date: June, 1983.]

➡➡➡ *The next page is 1905-21.* ⬅⬅⬅

⁴This does not alter the caveat in section 337.08 that "evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish."

AU Section 9350***Audit Sampling: Auditing
Interpretations of
AU Section 350*****1. Applicability**

.01 Question—Section 350, *Audit Sampling*, paragraph .01, footnote 1, states that there may be reasons other than sampling for an auditor to examine less than 100 percent of the items comprising an account balance or class of transactions. For what reasons might an auditor's examination of less than 100 percent of the items comprising an account balance or class of transactions *not* be considered audit sampling?

.02 Answer—The auditor's examination of less than 100 percent of the items comprising an account balance or class of transactions would not be considered to be an audit sampling application under the following circumstances.

a. *It is not the auditor's intent to extend the conclusion that he reaches by examining the items to the remainder of the items in the account balance or class.* Audit sampling is defined as the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class. Thus, if the purpose of the auditor's application of an auditing procedure to less than 100 percent of the items in an account balance or class of transactions is something other than evaluating a trait of the entire balance or class, he is not using audit sampling.

For example, an auditor might trace several transactions through an entity's accounting system to gain an understanding of the nature of the entity's operations or clarify his understanding of the design of the entity's internal accounting control system. In such cases the auditor's intent is to gain a general understanding of the accounting system or the system of internal accounting control, rather than the evaluation of a characteristic of all transactions processed by those systems. As a result, the auditor is not using audit sampling.

Occasionally auditors perform procedures such as checking arithmetical calculations or tracing journal entries into ledger

accounts on a test basis. When such procedures are applied to less than 100 percent of the arithmetical calculations or ledger postings that affect the financial statements, audit sampling may not be involved if the procedure is not a test to evaluate a characteristic of an account balance or class of transactions, but is intended only to provide limited knowledge that supplements the auditor's other evidential matter regarding a financial statement assertion.

b. *Although he might not be examining all the items in an account balance or class of transactions, the auditor might be examining 100 percent of the items in a given population.* A "population" for audit sampling purposes does not necessarily need to be an entire account balance or class of transactions. For example, in some circumstances, an auditor might examine all of the items that comprise an account balance or class of transactions that exceed a given amount or that have an unusual characteristic and either apply other auditing procedures (e. g., analytical review procedures) to those items that do not exceed the given amount or possess the unusual characteristic or apply no auditing procedures to them because of their insignificance. Again, the auditor is not using audit sampling. Rather, he has broken the account balance or class of transactions into two groups. One group is tested 100 percent, the other group is either tested by analytical review procedures or considered insignificant. The auditor would be using audit sampling only if he applied an auditing procedure to less than all of the items in the second group to form a conclusion about that group. For the same reason, cutoff tests often do not involve audit sampling applications. In performing cutoff tests auditors often examine all significant transactions for a period surrounding the cutoff date and, as a result, such tests do not involve the application of audit sampling.

c. *The auditor is compliance testing an internal accounting control that is not documented.* Auditors choose from a variety of methods including inquiry, observation, and examination of documentary evidence in testing compliance with internal accounting controls. For example, observation of a client's physical inventory count procedures is a test that is performed primarily through the auditor's observation of controls over such things as inventory movement, counting procedures and other procedures used by the client to control the count of the inventory. The procedures that the auditor uses to observe the client's physical inventory count generally do not require use of audit sampling. However, audit sampling may be used in certain compliance tests or substantive tests of details of inventory, for example, in tracing selected test counts into inventory records.

d. *The auditor is not performing a substantive test of details.* The auditor's reliance on substantive tests may be derived from tests of details of transactions and balances, from analytical review procedures, or from a combination of both. In performing substantive tests, audit sampling is generally used only in testing details of transactions and balances.

[Issue Date: January, 1985.]

➡➡➡ *The next page is 1907.* ⬅⬅⬅

AU Section 9410

Adherence to Generally Accepted Accounting Principles: Auditing Interpretations of AU Section 410

[1.] Accounting Principles Recommended by Trade Associations

[.01—.03] [Withdrawn August, 1982 by Statement on Auditing Standards No. 43.]

[2.] The Impact of FASB Statement No. 2 on Auditor's Report Issued Prior to the Statement's Effective Date²

[.04—.12] [Superseded October, 1979 by Interpretation No. 3, paragraphs .13—.19.]

3. The Impact on an Auditor's Report of an FASB Statement Prior to the Statement's Effective Date

.13 *Question*—What is the impact on the auditor's report when he is reporting on financial statements issued before the effective date of a Statement of Financial Accounting Standards and the financial statements will have to be restated in the future because the FASB statement will require retroactive application of its provisions by prior period adjustment?

.14 *Interpretation*—In considering whether financial statements are presented in conformity with generally accepted accounting principles (GAAP), section 411.10 states: "The auditor should be familiar with alternative accounting principles that may be applicable to the transaction or facts under consideration and realize that *an accounting principle may have only limited usage but still have general acceptance.*" (Italics added.) [Reference changed by the issuance of Statement on Auditing Standards No. 43.]

.15 For example, Financial Accounting Standards Board Statement No. 2 [AC section R50], *Accounting for Research and Development Costs*, was issued in October 1974, but was effective for fiscal

➡ The next page is 1907-3. ←

¹ [Reserved.]

² Originally issued under the title "Effect on the Auditor's Opinion of FASB Statement on Research and Development Costs" (*Journal of Accountancy*, Jan. '75, p. 74).

years beginning on or after January 1, 1975. This Statement requires companies to expense research and development costs encompassed by the Statement in the period they are incurred. Companies that had deferred research and development costs were required to restate their financial statements by prior period adjustment in the period in which FASB Statement No. 2 [AC section R50] became effective. Deferring research and development costs before FASB Statement No. 2 [AC section R50] became effective was an acceptable alternative principle under GAAP, although FASB Statement No. 2 [AC section R50] proscribed such treatment for fiscal years beginning on or after January 1, 1975. Where the accounting principles being followed are currently acceptable, the auditor should not qualify his report if a company does not adopt before an FASB Statement becomes effective accounting principles that will be prescribed by that Statement. Other reporting considerations are addressed in the following paragraphs.

.16 Section 509.17 (see Appendix G) states: "Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements." Similarly, APB Statement No. 4, paragraph 106 on adequate disclosure states: "The headings, captions and amounts must be supplemented by enough additional data so that their meaning is clear. . . ." For financial statements that are prepared on the basis of accounting principles that are acceptable at the financial-statement date but that will not be acceptable in the future, the auditor should consider whether disclosure of the impending change in principle and the resulting restatement are essential data. If he decides that the matter should be disclosed and it is not, the auditor should express a qualified or adverse opinion as to conformity with GAAP, as required by section 545.01 (see Appendix G).

.17 To evaluate the adequacy of disclosure of the prospective change in principle, the auditor should assess the potential effect on the financial statements. Using the research and development cost example given above, the effect of the anticipated prior period adjustment to write off previously deferred research and development costs would in some instances be so material that disclosure would be essential for an understanding of the financial statements. In cases such as this, where the estimated impact is so material, disclosure can best be made by supplementing the historical financial statements with pro forma financial data that give effect to the future adjustment as if it had occurred on the date of the balance sheet. (See section 560.05.) The pro forma data may be presented in columnar form alongside the historical statements, in the notes to the historical statements, or in separate pro forma statements presented with the historical statements.

.18 Even if the auditor decides that the disclosure of the forthcoming change and its effects are adequate and, consequently, he decides not to qualify his opinion, he nevertheless may decide to include an explanatory paragraph in his report if the effects of the change are expected to be unusually material. The explanatory paragraph should not be construed as a qualification of the auditor's opinion; it is intended to highlight circumstances of particular importance and to aid in interpreting the financial statements (see section 509.27 in Appendix G).

.19 The auditor should also consider the effect of an uncertainty that may result upon a required future adoption of an accounting principle. For example, such an uncertainty may arise where the future adoption of such a principle will result in a reduction to stockholders' equity that may cause the company to be in violation of its debt covenants, which in turn may accelerate the due date for repayment of debt. In such case, the auditor should consider the effect on his report of the uncertainty and if he concludes a material uncertainty exists, he should appropriately qualify his opinion (see section 509.21—.26 in Appendix G).

[Issue Date: October, 1979.]

➤➤➤→ *The next page is 1911.* ←➤➤➤

AU Section 9420

Consistency of Application of Generally Accepted Accounting Principles: Auditing Interpretations of AU Section 420

[1.] The Effect of APB Opinion No. 30 on Consistency¹

[.01—.10] [Superseded October, 1979 by Interpretation No. 5, paragraphs .28—.31.]

2. The Effect of APB Opinion No. 28 on Consistency

.11 *Question*—Independent auditors may be engaged to report on financial information for an annual period and a subsequent interim period. Should the auditor qualify his opinion as to consistency in those circumstances where accounting principles and practices used in preparing the annual financial information have been modified in accordance with APB Opinion No. 28 [AC section I73] in preparing the interim financial statements?

.12 *Response*—No. The auditor should not qualify his opinion as to consistency. Although the modifications deemed appropriate under Opinion No. 28 [AC section I73] may appear to be changes in the methods of applying accounting principles, they differ from changes in methods that require a consistency qualification since the modifications are made in order to recognize a difference in circumstances, that is, a difference between presenting financial information for a year and presenting financial information for only a part of a year.

.13 Section 420.02 states: "The objective of the consistency standard is (a) to give assurance that the comparability of financial statements between periods has not been materially affected by changes in accounting principles . . . or (b) if comparability has been materially affected by such changes, to require appropriate reporting by the independent auditor regarding such changes." Section 420.02 refers to changes in methods that lessen the usefulness of financial statements in comparing the financial information of one period with that of an earlier period. Thus, the purpose of an exception as to consistency in the auditor's report is to alert readers of the report not to make an unqualified comparison of the financial information for the two periods.

.14 The modifications introduced by Opinion No. 28 [AC section I73], however, do not lessen the comparability of the financial information of an interim period with that of a preceding annual period. On the contrary, those modifications are intended to enhance com-

¹Originally issued under the title "Reporting on Consistency and Extraordinary Items" (*Journal of Accountancy*, Jan. '74, p. 67).

parability between the two sets of financial information. As paragraph 10 of Opinion No. 28 [AC section I73.103] states, the modifications are needed "so that the reported results for the interim period may better relate to the results of operations for the annual period."

.15 Thus the modifications introduced by Opinion No. 28 [AC section I73] are not of the type that would require a qualification of the auditor's opinion as to consistency. Independent auditors should, of course, qualify their opinions as to consistency if changes of the type that lessen comparability are introduced in the interim financial information.

[Issue Date: February, 1974.]

3. Impact on the Auditor's Report of FIFO to LIFO Change in Comparative Financial Statements

.16 *Question*—Changing economic conditions have caused some companies to change their inventory pricing methods from the first in, first out (FIFO) method to the last in, first out (LIFO) method. When a company presents comparative financial statements and the year of the FIFO to LIFO change is the earliest year both presented and reported on, should the auditor refer to that change in accounting principle in his report?

.17 *Interpretation*—Ordinarily, the auditor need not refer in his report to a FIFO to LIFO change in the circumstances described above.

.18 A change in accounting principle usually results in including the cumulative effect of the change in net income of the period of the change. A change in inventory pricing method from FIFO to LIFO, however, is a change in accounting principle that ordinarily does not affect retained earnings at the beginning of the period in which the change was made. (See APB Opinion No. 20, paragraphs 14(d) and 26.)²

.19 An example of typical disclosure of a FIFO to LIFO change in the year of the change is as follows:

"In 1974, the company adopted the last in, first out (LIFO) method of costing inventory. Previously, the first in, first out (FIFO) method of costing inventory was used. Management believes that the LIFO method has the effect of minimizing the impact of price level changes on inventory valuations and generally matches current costs against current revenues in the income statement. The effect of the change was to reduce net income by \$xxxx (\$xx per share) from that which would otherwise have been reported. There is no cumulative effect on prior years since the ending inventory as previously reported

² AC section A06.122.

(1973) is the beginning inventory for LIFO purposes. Accordingly, pro forma results of operations for the prior year had LIFO been followed is not determinable."

.20 Section 420.19 discusses the periods to which the consistency standard relates: "When the independent auditor reports on two or more years, he should report on the consistency of the application of accounting principles between such years. . . ." If the change from FIFO to LIFO was made in the earliest year both presented and reported on, the principle has been applied consistently in the comparative financial statements. [Reference changed by the issuance of Statement on Auditing Standards No. 43.]

.21 Section 546.03 (see Appendix G), discusses reporting on changes in accounting principle that should be accounted for by means other than by restating the financial statements of prior years. Thus, it applies to accounting changes accounted for in the current period, such as FIFO to LIFO. It states, in pertinent part: "If the year of change is the earliest year being reported upon, there is no inconsistency in the application of accounting principles during the period subsequent to the change, but the auditor should make reference to the change having been made in such year."

.22 Section 546.03 (see Appendix G) requires the auditor to refer to a change made in the earliest period reported on even though there is no inconsistency in the application of accounting principles because of a lack of comparability between the earliest year statements and those of subsequent years that results from presenting a material cumulative effect in the earliest year. Factors affecting comparability but not consistency ordinarily need not be commented on by the auditor (see section 420.05), but when comparability is affected by a change in accounting principle the auditor should refer to the change in his report.

.23 For a FIFO to LIFO change made in the earliest year presented and reported on, there is no inconsistency in the application of accounting principles, and comparability between the earliest year and subsequent years is not affected since no cumulative effect is reported in the year of the change. Consequently, the independent auditor need not refer to the change in inventory pricing methods.

[Issue Date: January, 1975.]

4. The Effect of FASB Statement No. 13 on Consistency

.24 *Question*—Statement of Financial Accounting Standards No. 13 [AC section L10], *Accounting for Leases*, applies to leasing transactions and lease agreement revisions entered into on or after January 1, 1977. Lease transactions preceding that date need not be retroactively restated in the financial statements until the fiscal year begin-

ning after December 31, 1980. (In the context of this question, and with respect to enterprises having a fiscal year of 52 or 53 weeks, "December 31" includes dates within the last seven days of December or the first seven days of January.) If an entity changes its method of accounting for leases entered into in 1977 to conform with FASB Statement No. 13 [AC section L10], and does not initially retroactively apply the provisions of the Statement to leases that existed or were committed as of December 31, 1976, what is the effect on the auditor's report on the financial statements for 1977 and subsequent years?

.25 Interpretation—Paragraph 7 of APB Opinion No. 20 [AC section A06.105], *Accounting Changes*, states, "A change in accounting principle results from the adoption of a generally accepted accounting principle different from the one used previously for reporting purposes." Since the entity has adopted a new accounting principle for lease transactions entered into in the current year, as required by FASB Statement No. 13 [AC section L10], a change in accounting principle has occurred. Section 420.05 states, "Changes in accounting principle having a material effect on the financial statements require recognition in the independent auditor's opinion as to consistency." Consequently, if there is a material effect on the financial statements in the first year that leases entered into on or after January 1, 1977, are accounted for in conformity with FASB Statement No. 13 [AC section L10], the auditor should give recognition in his report to the inconsistency.

.26 In subsequent years, but before the year in which the entity restates its financial statements, the auditor need not qualify his opinion as to consistency, provided the earliest year presented does not precede the year of change. In such circumstances, there is no inconsistency in the application of accounting principles and comparability between the earliest year and subsequent years is not affected, since no cumulative effect is reported in the year of the change.

.27 In the year that the entity restates its financial statements retroactively for leases entered into or committed before January 1, 1977, the auditor should also qualify his opinion as to consistency. Although the entity previously disclosed in the financial statements the relevant information for leases existing as of December 31, 1976, the actual restatement of prior years' financial statements requires the auditor to comment on consistency in his report (see section 546.02 in Appendix G).

[Issue Date: January, 1978.]

* [Footnote deleted.]

5. The Effects of Changes in Accounting Principles and Classification on Consistency

.28 *Question*—In what circumstances, if any, should an auditor qualify his opinion as to the consistent application of accounting principles when there has been a change in financial statement classification?

.29 *Interpretation*—Section 420.14 states: "Classifications in the current financial statements may be different from classifications in the prior year's financial statements. . . . These changes . . . ordinarily would not affect the independent auditor's opinion as to consistency and need not be referred to in his report." An example of the type of change contemplated by section 420.14 is combining "Cash on hand" with "Cash in bank" to create a new classification, "Cash."

.30 However, section 420.14 does not contemplate a change in classification that affects significantly the *measurement* of financial position or results of operations. Such a change would call for a consistency qualification in the auditor's report. For example, APB Opinion No. 30 [AC sections I13 and I17] changed significantly the types of items that are to be reported as extraordinary, and this in turn changed the measurement of "income before extraordinary items" and the related per share amounts. Many accountants believe that the amount of income before extraordinary items is a very important aspect of an income statement. As evidence of its importance, APB Opinion No. 15 [AC section E09] requires that earnings per share be presented for income before extraordinary items. By changing the determination of income before extraordinary items, Opinion No. 30 [AC sections I13 and I17] changed the *measurement* of results of operations.

.31 Such a change would call for a consistency qualification whether or not it was elective or mandatory. In either case, if the change in principle has a material effect on comparability, the auditor should comment on the change in his report and should qualify his opinion as to consistency unless the financial statements for the prior year have been restated to apply the change retroactively.

[Issue Date: October, 1979.]

6. The Effect of FASB Statement No. 34 on Consistency

.32 *Question*—Statement of Financial Accounting Standards No. 34 [AC section I67], *Capitalization of Interest Cost*, is to be applied prospectively in fiscal years beginning after December 15, 1979. Earlier application is permitted, but not required.

.33 Among other matters, the Statement prescribes the method of determining the amount of interest cost to be capitalized and restricts the types of assets which qualify for interest capitalization.

Consequently, some entities that capitalized interest costs in their 1978 financial statements may need to:

a change their method of determining capitalized interest in their 1980 statements (1979, if earlier application is adopted) to conform with the provisions of FASB Statement No. 34 [AC section I67], or

b discontinue capitalizing interest costs in their 1980 statements (1979, if earlier application is adopted) with respect to those assets that do not qualify under FASB Statement No. 34 [AC section I67].

.34 In either event, no adjustment to the amounts of interest cost previously capitalized is to be made.

.35 Conversely, an entity that did not capitalize interest cost in its 1978 statements may need to begin capitalizing interest with respect to its existing qualifying assets prospectively in its 1980 statements (1979, if earlier application is adopted).

.36 Under the circumstances described above, should the auditor's report on the entity's financial statements be qualified as to consistency of application of generally accepted accounting principles for 1980 (1979 if earlier application is adopted) and subsequent years?

.37 *Interpretation*—APB Opinion No. 20, *Accounting Changes*, par. 7 [AC section A06.105], states: "A change in accounting principle results from the adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term *accounting principle* includes not only accounting principles and practices, but also the methods of applying them." Also, section 420.05 states, "Changes in accounting principle having a material effect on the financial statements require recognition in the independent auditor's opinion as to consistency."

.38 Since under each of the circumstances described above, the entity has adopted a new accounting principle or new method for determining interest costs to be capitalized in the current year, a change in accounting principle has occurred. Thus, if the change has a material effect on the financial statements in the first year that the provisions of FASB Statement No. 34 [AC section I67] are adopted, the auditor should give recognition in his report to the inconsistency (see section 546.03).

.39 The auditor's reporting decision should not be influenced by the fact that the company's change in accounting principle does not result from an election, but instead was made necessary by the adoption of an FASB Statement. As discussed in section 420.02:

"The objective of the consistency standard is (a) to give assurance that the comparability of financial statements between periods has

not been materially affected by changes in accounting principles, which include not only accounting principles and practices but also the methods of applying them, or (b) if comparability has been materially affected by such changes, to require appropriate reporting by the independent auditor regarding such changes."

.40 The effect of a change in accounting principles on the comparability of financial statements is the same, whether the accounting change is elective or mandatory. In either case, if the change in principles has a material effect on comparability, the auditor should comment on the change in his report and should qualify his opinion as to consistency unless the financial statements for the prior year have been restated to apply the change retroactively (not permissible in the cases under discussion).

.41 In subsequent years, the auditor need not qualify his opinion as to consistency provided the earliest year presented does not precede the year of change. In such circumstances, there will be no inconsistency in the application of accounting principles and comparability between the earlier year and subsequent years will not be affected, since no cumulative effect will be reported in the year of change.

.42 The effect of interest capitalization and its subsequent amortization or other disposition under FASB Statement No. 34 [AC section I67] compared with the effect of charging it to expense when incurred, may not be material. Section 420.17, in the context of changes expected to have a material future effect, states: "If an accounting change has no material effect on the financial statements in the current year, but the change is reasonably certain to have substantial effect in later years, the change should be disclosed in the notes to the financial statements whenever the statements of the period of change are presented, but the independent auditor need not recognize the change in his opinion as to consistency." [Reference number 420.17, formerly 420.18, changed by the issuance of Statement on Auditing Standards No. 43.]

.43 Also, if the type of asset affected by the criteria of FASB Statement No. 34 [AC section I67] exists, or the entity incurs interest, in only one of the years presented, the auditor need not qualify his opinion as to consistency.

[Issue Date: February, 1980.]

7. The Effect of FASB Statement No. 31 on Consistency

.44 *Question*—The FASB recently issued its Statement No. 31 [AC section I42.130-135] to specify how an enterprise subject to United States generally accepted accounting principles should account for income taxes relating to recent changes in the United Kingdom tax law concerning "stock relief," which permits an income tax deduction for increases in inventory. The changes in the tax law modified the

provisions for recapture of the tax benefit of that deduction. Statement No. 31 [AC section I42] requires that certain previously deferred tax benefits related to "stock relief" be recognized as of July 26, 1979, when the legislation was enacted. Other tax benefits related to "stock relief" should be deferred unless it is probable that those tax benefits will not be recaptured.

.45 Does the effect of the application of the provisions of Statement No. 31 [AC section I42], if material, require an independent auditor to modify his opinion as to consistency of application of generally accepted accounting principles in the auditor's report?

.46 *Interpretation*—No. While the application of the provisions of Statement No. 31 [AC section I42] will result in a lack of comparability of financial statements between years, this is not caused by a change in accounting principle. Thus, the auditor should not modify his report.

.47 The FASB concluded that "the change in the U. K. tax law with regard to 'stock relief' creates a unique situation in accounting for income taxes . . ." (Statement No. 31, paragraph 2 [AC section I42.134]). The legislation eliminated the potential for recapture of "stock relief" tax benefits in 1973-1974 and 1974-1975 fiscal years, and provided for the termination of the potential for recapture of a benefit received in a subsequent year if it is not recaptured during a six-year period. Thus, the new legislation created a new type of tax item, that does not have the character of either a timing difference or a permanent difference. An item of this type has no exact counterpart in the U. S. tax law and is not specifically covered by APB Opinion No. 11, "Accounting For Income Taxes."

.48 Section 420.04 states that "A comparison of the financial statements of an entity between years may be affected by . . . events or transactions substantially different from those accounted for in previously issued statements." Sections 420.12 and 420.16 discuss two types of such events, either of which could be considered to characterize the change in the U. K. tax law with regard to "stock relief." [Reference number 420.16, formerly 420.17, changed by the issuance of Statement on Auditing Standards No. 43.]

.49 Section 420.12 states:

Accounting estimates change as new events occur. . . . This type of accounting change is required by altered conditions that affect comparability but do not involve the consistency standard. The independent auditor . . . need not comment on the change in his report because it does not affect his opinion as to consistency. However, an accounting change of this type having a material effect on the financial statements may require disclosure in a note to the financial statements.

.50 Section 420.16 states that "modification or adoption of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring, do not involve the consistency standard although disclosure in the notes to the financial statements may be required." [Reference changed by the issuance of Statement on Auditing Standards No. 43.]

.51 In accordance with section 420.12, the auditor should satisfy himself "with respect to the conditions giving rise to the change in accounting estimate" when management adjusts previous deferrals based on a revision of its judgment concerning recapture.

[Issue Date: March, 1980.]

8. The Effect of Accounting Changes by an Investee on Consistency

.52 *Question*—Does a change in accounting principle by an investee accounted for by the equity method require a reference to consistency in the auditor's report on the financial statements of the investor?

.53 *Interpretation*—Changes in accounting principle affect the comparability of financial statements regardless of whether such changes originate at the investor level or are made solely by an investee.⁴ Section 420.02 states: "The objective of the consistency standard is (a) to give assurance that the comparability of financial statements between periods has not been materially affected by changes in accounting principles . . . or (b) if comparability has been materially affected by such changes, to require appropriate reporting by the independent auditor regarding such changes."

.54 Thus, the auditor would need to modify his opinion as to consistency when there has been a change in accounting principle by an investee accounted for by the equity method that causes a material lack of comparability in the financial statements of an investor.

.55 The form of modification of the auditor's opinion that is appropriate depends on the manner in which the change is reported in the financial statements of the investor. Although the equity method is generally considered a "one-line" consolidation, a change in accounting principle that is accounted for either by a cumulative effect adjustment or a restatement of prior years' financial statements would, if material, be classified in the same manner in the financial statements of the investor (see APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, paragraph 19d [AC section 182.109d]). Accordingly, if the investee's change in accounting prin-

⁴For a discussion of comparability of financial statements of a single enterprise, see paragraphs 95 through 97 of Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises".

ciple is one which should be reported by restating the financial statements of prior periods (for example, a change from LIFO to FIFO) the auditor of the investor's financial statements should, in accordance with section 546.02 (see Appendix G), report that the statements are consistent after giving retroactive effect to the change. If, on the other hand, the investee's change in accounting principle is one which should be reported either by including a cumulative effect adjustment in the income statement for the year of change (for example, a change in depreciation method for all assets in a class) or accounted for in the current period (for example, a change from FIFO to LIFO) the auditor of the investor's financial statements should, in accordance with section 546.03 (see Appendix G), report that accounting principles have been consistently applied except for the change.

.56 If an auditor of the financial statements of the investor (the "principal auditor") makes reference in his report to the examination of the investee's financial statements by another auditor, he should also make reference in his report to the other auditor's concurrence with any accounting changes (see section 543.14-15). This could be done in the scope paragraph or in the opinion paragraph. If reference is made to the other auditor's concurrence in the opinion paragraph, a phrase similar to the following would be added: "except for [after restatement for] the change in accounting, with which the other auditors have expressed their concurrence, by the (investee company)" The principal auditor would not also have to express concurrence with the change.

.57 If the principal auditor does not make reference in his report to the examination of the other auditor, the principal auditor should make whatever inquiries or perform whatever procedures he deems necessary in the circumstances to satisfy himself as to the appropriateness of the change (see section 543.12) and he should state his concurrence with the investee's change in accounting.

[Issue Date: July, 1980.]

9. The Effect of Adoption of FASB Statement No. 35 on Consistency

.58 *Question*—Statement of Financial Accounting Standards No. 35 [AC section Pe5], *Accounting and Reporting by Defined Benefit Pension Plans*, establishes standards of financial accounting for defined benefit pension plans and prescribes the general form and content of the financial statements of those plans.

.59 FASB Statement No. 35 [AC section Pe5] is effective for plan years beginning after December 15, 1980, but earlier application is encouraged. Financial statements of prior plan years are required to be restated to comply with the provisions of the Statement only if

presented together with financial statements for plan years beginning after December 15, 1980.

.60 What is the effect on the auditor's reference to the consistency of application of accounting principles when a plan prepares its financial statements following the provisions of FASB Statement No. 35 [AC section Pe5]?

.61 *Interpretation*—The adoption of the provisions of FASB Statement No. 35 [AC section Pe5] may result in changes in accounting principles. For example, a plan may be required to change from the cash basis to the accrual basis of accounting, from the cost basis to the fair value basis for reporting investments, or from recording employee receivables in symmetry with sponsor accruals (or not recording employee receivables) to the method of recording such receivables prescribed by FASB Statement No. 35 [AC section Pe5].

.62 Changes in accounting principles, such as those described above, that have a material effect on the financial statements require recognition in the independent auditor's opinion as to consistency. Section 546.02-.03 describes the auditor's reporting responsibilities when there has been a change in accounting principles that has a material effect on the financial statements.

.63 FASB Statement No. 35 [AC section Pe5] specifies that the financial statements of a defined benefit pension plan include information regarding the actuarial present value of accumulated plan benefits and changes therein. The adoption of the provisions of FASB Statement No. 35 [AC section Pe5] may result in the presentation of information regarding accumulated plan benefits that differs from or is in addition to the benefit information provided in prior years' financial statements. A change in the presentation of benefit information from that which was provided in prior years is new or additional information and thus is not a change in accounting principle that requires reference in the auditor's opinion as to consistency.

[Issue Date: December, 1980.]

10. Change in Presentation of Accumulated Benefit Information in the Financial Statements of a Defined Benefit Pension Plan

.64 *Question*—FASB Statement No. 35 [AC section Pe5], *Accounting and Reporting by Defined Benefit Pension Plans*, requires the presentation of information regarding the actuarial present value of accumulated plan benefits and year-to-year changes therein of a defined benefit pension plan but permits certain flexibility in presenting such information. The information may be included on the face of a financial statement (a separate statement or one that combines accumu-

lated benefit information with asset information), or it may be included in the notes to the financial statements. Furthermore, the benefit information may be as of the beginning of the period being reported upon or as of the end of that period. Does a change in the format of presentation of accumulated benefit information or a change in the date as of which such information is presented require a reference in the auditor's opinion as to consistency?

.65 Interpretation—Such changes in the presentation of information regarding accumulated benefits are considered reclassifications or variations in the nature of information presented. Changes such as these that are material should be explained in the financial statements or notes, but these changes ordinarily would not affect the auditor's opinion as to consistency and need not be referred to in his report (see section 420.14).

[Issue Date: December, 1980.]

11. The Effect of the Adoption of FASB Statement No. 36 on Consistency

.66 Question—FASB Statement No. 36 [AC section P15.130-132 and P15.134], *Disclosure of Pension Information*, revised the required disclosures in the employer's financial statements about defined benefit pension plans. The revised disclosures include the actuarial present value of accumulated plan benefits and the pension plan assets available for those benefits, both as determined in accordance with FASB Statement No. 35 [AC section Pe5], *Accounting and Reporting by Defined Benefit Pension Plans*. The Statement is effective for annual financial statements for fiscal years beginning after December 15, 1979.

.67 Does the change in disclosure required by FASB Statement No. 36 [AC section P15] necessitate a reference in the auditor's report as to consistency in the financial statements of an employer?

.68 Interpretation—No. The change in disclosure provides additional information in the employer's financial statements and is not a change that requires a reference as to consistency in the auditor's opinion.

[Issue Date: December, 1980.]

➡ The next page is 1919. ⬅

AU Section 9504***Association With Financial Statements:
Auditing Interpretations
of AU Section 504*****1. Annual Report Disclosure of Unaudited Fourth Quarter Interim Data**

.01 Question—APB Opinion No. 28, paragraph 31 [AC section I73.147], which applies to publicly traded companies, states: “When interim financial data and disclosures are not separately reported for the fourth quarter, security holders often make inferences about that quarter by subtracting data based on the third quarter interim report from the annual results. In the absence of a separate fourth quarter report or disclosure of the results . . . for that quarter in the annual report, disposals of segments of a business and extraordinary, unusual, or infrequently occurring items recognized in the fourth quarter, as well as the aggregate effect of year-end adjustments which are material to the results of that quarter . . . should be disclosed in the annual report in a note to the annual financial statements.” Does the auditor have an obligation, arising from the disclosure requirements of paragraph 31 of Opinion No. 28 [AC section I73.147], to audit interim data?

.02 Interpretation—No. If the auditor has not been specifically engaged to audit interim information, he does not have an obligation to audit interim data as a result of his examination of the annual financial statements.

.03 Disclosure of fourth quarter adjustments and other disclosures required by paragraph 31 [AC section I73.147] would appear in a note to the annual financial statements of a publicly traded company only if fourth quarter data were not separately distributed or did not appear elsewhere in the annual report. Consequently, such disclosures are not essential for a fair presentation of the annual financial statements in conformity with generally accepted accounting principles.

.04 If interim financial data and disclosures are not separately reported (as outlined in paragraph 30 of Opinion No. 28 [AC section I73.146]) for the fourth quarter, the independent auditor during his examination of the annual financial statements should inquire as to whether there are fourth quarter items that need to be disclosed in a note to the annual financial statements.

.05 Information on fourth quarter adjustments and similar items that appear in notes to the annual financial statements to comply with paragraph 31 of Opinion No. 28 [AC section I73.147] would ordinarily not be audited separately and, therefore, the information would be labeled “unaudited” or “not covered by auditor’s report.”

.06 If a publicly traded company fails to comply with the provisions of paragraph 31 of Opinion No. 28 [AC section I73.147], the auditor should suggest appropriate revision; failing that, he should call attention in his report to the omission of the information. The auditor need not qualify his opinion on the annual financial statements since the disclosure is not essential for a fair presentation of those statements in conformity with generally accepted accounting principles.

.07 Reference should be made to section 722* for guidance with respect to reviews of interim financial information of public entities.

[Issue Date: November, 1979.]

[2.] Association of the Auditor of an Acquired Company With Unaudited Statements in a Listing Application

[.08—.12] [Deleted May, 1980.]

[3.] Association of the Auditor of the Acquiring Company With Unaudited Statements in a Listing Application

[.13—.14] [Deleted May, 1980.]

4. Auditor's Identification With Condensed Financial Data

.15 *Question*—Section 150.02 states in part: "In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking." Section 504.03 states that "An accountant is associated with financial statements when he has consented to the use of his name in a report, document, or written communication containing the statements." Is the auditor "associated" with condensed financial data when he is identified by a financial reporting service as being a company's independent auditor or when his report is reproduced and presented with such data?

.16 *Interpretation*—No. The accountant has not consented to the use of his name when it is published by a financial reporting service. Financial data released to the public by a company and the name of its auditor are public information. Accordingly, neither the auditor nor his client has the ability to require a financial reporting service to withhold publishing such information.

.17 Financial reporting services, such as Dun & Bradstreet and Moody's Investors Service, furnish to subscribers information and ratings concerning commercial enterprises as a basis for credit, insurance, marketing and other business purposes. Those reports frequently include condensed financial data and other data such as payments to trade creditors, loan experience with banks, a brief history of the entity and a description of its operations. Also, as part of its report, the financial service often discloses the names of the officers and directors or principals or owners of the company and the name of the company's auditor.

.18 In the context in which the auditor's name appears, it is doubtful that readers will assume that he has audited the information presented. However, the AICPA has suggested to certain financial reporting services that they identify data as "unaudited" if the data has been extracted from unaudited financial statements. Also, the AICPA has suggested that when summarized financial data is presented together with an auditor's report on complete financial statements (including notes), the financial reporting services state that the auditor's report applies to financial statements not presented.

[Issue Date: November, 1979.]

* Reference changed by issuance of SAS No. 36.

5. Applicability of Guidance on Reporting When Not Independent

.19 Question—Section 504 describes the reporting responsibilities of the certified public accountant who has determined that he is not independent with respect to financial statements with which he is associated. That section, however, does not indicate how he should determine whether he is independent. What should the certified public accountant consider in determining whether he is independent? Also, should his consideration be any different for an engagement to prepare unaudited financial statements?

.20 Interpretation—Section 504 explains the certified public accountant's reporting responsibilities when he is not independent. However, it does not attempt to explain how the certified public accountant determines whether he is independent because that is a question of professional ethics. Section 220.04 states: "The profession has established, through the Institute's Code of Professional Ethics, precepts to guard against the . . . loss of independence." The AICPA, state CPA societies and state boards of accountancy have issued pronouncements to provide the certified public accountant with guidance to aid him in determining whether he is independent.

.21 The certified public accountant should consider the AICPA's Code of Professional Ethics, its Rules of Conduct, Interpretations under the Rules and Ethics rulings in determining whether he is independent and whether the reporting requirements of section 504 apply. He should also consider the ethical requirements of his state CPA society or state board of accountancy.

.22 Section 504.10 states that the reporting guidance applies, *regardless of the extent of procedures applied*, (emphasis added) in all circumstances other than when the financial statements are those of a non-public entity.¹ Thus, the accountant's consideration of whether he is independent should be the same whether the financial statements are audited or unaudited.

[Issue Date: November, 1979.]

6. Reporting on Solvency^[2]

[.23—.35] [Rescinded May, 1988 by the issuance of attestation interpretation, "Responding to Requests for Reports on Matters Relating to Solvency."]¹ (See section 2012.)

[Issue Date: December, 1984.]

[The next page is 1931.]

¹ If the financial statements are those of a non-public entity, the accountant should look to the guidance in Statements on Standards for Accounting and Review Services.

^[2] [Rescinded May, 1988 by the issuance of attestation interpretation "Responding to Requests for Reports on Matters Relating to Solvency."]¹ (See Section 2012.)

AU Section 9508***Reports on Audited Financial
Statements: Auditing
Interpretations of
AU Section 508*****1. Report of an Outside Inventory-Taking Firm as an Alternative Procedure for Observing Inventories**

.01 Question—Section 509.12 (see Appendix G) states that “common restrictions on the scope of the auditor’s examination include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . .” A footnote to that paragraph states: “Circumstances such as the timing of his work may make it impracticable or impossible for the auditor to accomplish these procedures. In such case, if he is able to satisfy himself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of his work, and his report need not include reference to the omission of the procedures or to the use of alternative procedures.” Outside firms of nonaccountants specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor’s own observation of physical inventories?

.02 Interpretation—Sufficient competent evidential matter for inventories is discussed in section 331.09—.12. Section 331.09 states that “. . . it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests, and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client’s representations about the quantities and physical condition of the inventories.”

.03 Section 331.10—.11 discusses two variations of that procedure when the client has well-kept perpetual records that are checked periodically by comparisons with physical counts or when the client uses statistical sampling to determine inventories. In such instances, the auditor may vary the timing and extent of his observation of physical counts, but he “must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used.”

.04 Section 331.12 deals with circumstances in which the auditor has not satisfied himself as to inventories in the possession of the client through procedures described in section 331.09—.11. In those circumstances, the general requirement for satisfactory alternative procedures is that “. . . tests of the accounting records alone will not be sufficient for him to become satisfied as to quantities; it will always be necessary for the auditor to make,

or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions."

.05 The fact that the inventory is counted by an outside inventory firm of nonaccountants is not, by itself, a satisfactory substitute for the auditor's own observation or taking of some physical counts. The auditor's concern, in this respect, is to satisfy himself as to the effectiveness of the counting procedures used. If the client engages an outside inventory firm to take the physical inventory, the auditor's primary concern would be to evaluate the effectiveness of the procedures used by the outside firm and his auditing procedures would be applied accordingly.

.06 Thus, the auditor would examine the outside firm's program, observe its procedures and controls, make or observe some physical counts of the inventory, recompute calculations of the submitted inventory on a test basis and apply appropriate tests to the intervening transactions. The independent auditor ordinarily may reduce the extent of his work on the physical count of inventory because of the work of an outside inventory firm, but any restriction on the auditor's judgment concerning the extent of his contact with the inventory would be a scope restriction.

[Issue Date: July, 1975.]

[2.] Reporting on Comparative Financial Statements of Nonprofit Organizations

[.07—.10] [Superseded by Statement on Auditing Standards No. 15, effective for periods ending after June 30, 1977.] (See section 505 in Appendix G.)

[3.] Reporting on Loss Contingencies

[.11—.14] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

[4.] Reports on Consolidated Financial Statements That Include Supplementary Consolidating Information

[.15—.20] [Superseded December 31, 1980, by SAS No. 29.] (See section 551.)

[5.] Disclosures of Subsequent Events

[.21—.24] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

[6.] The Materiality of Uncertainties

[.25—.28] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

[7.] Reporting on an Uncertainty

[.29—.32] [Withdrawn August, 1982 by Statement on Auditing Standards No. 43.]

8. Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting

.33 Question—APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, states that if liquidation of an entity appears imminent, financial information may be prepared on the assumption that liquidation will occur. How should the auditor report on financial statements that are prepared on a liquidation basis of accounting for an entity in liquidation or for which liquidation appears imminent?

.34 Answer—A liquidation basis of accounting may be considered generally accepted accounting principles for entities in liquidation or for which liquidation appears imminent. Therefore, the auditor should issue an unqualified opinion on such financial statements, provided that the liquidation basis of accounting has been properly applied, that adequate disclosures are made in the financial statements and that the financial statements are not affected by a significant uncertainty.

.35 Typically, the financial statements of entities that adopt a liquidation basis of accounting are presented along with financial statements of a period prior to adoption of a liquidation basis that were prepared on the basis of generally accepted accounting principles for going concerns. In such circumstances, the auditor's report ordinarily should include an explanatory paragraph that states that the entity has changed the basis of accounting used to determine the amounts at which assets and liabilities are carried from the going concern basis to a liquidation basis.

.36 Examples of auditor's reports with such an explanatory paragraph follow.

Report on Single Year Financial Statements in Year of Adoption of Liquidation Basis

"We have examined the statement of net assets in liquidation of XYZ Company as of December 31, 19X2, and the related statement of changes in net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2. In addition, we have examined the statements of income, retained earnings, and changes in financial position for the period from January 1, 19X2 to April 25, 19X2. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

"As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 19X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 19X2 from the going-concern basis to a liquidation basis.

"In our opinion, the financial statements referred to above present fairly the net assets in liquidation of XYZ Company as of December 31, 19X2, the changes in its net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2, and the results of its operations and the changes in its financial position for the period from January 1, 19X2 to April 25, 19X2, in conformity with generally accepted accounting principles applied on the bases described in the preceding paragraph."

Report on Comparative Financial Statements in Year of Adoption of Liquidation Basis

"We have examined the balance sheet of XYZ Company as of December 31, 19X1, the related statements of income, retained earnings, and changes in financial position for the year then ended, and the statements of income, retained earnings, and changes in financial position for the period from January 1, 19X2 to April 25, 19X2. In addition, we have examined the statement of net assets in liquidation as of December 31, 19X2, and the

related statement of changes in net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

"As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 19X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 19X2 from the going-concern basis to a liquidation basis.

"In our opinion, the financial statements referred to above present fairly the financial position of XYZ Company as of December 31, 19X1, the results of its operations and the changes in its financial position for the year then ended and for the period from January 1, 19X2 to April 25, 19X2, its net assets in liquidation as of December 31, 19X2, and the changes in its net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2, in conformity with generally accepted accounting principles applied on the bases described in the preceding paragraph."

.37 The auditor may, in subsequent years, continue to include an explanatory paragraph in his report to emphasize that the financial statements are presented on a liquidation basis of accounting.

.38 Sometimes financial statements presented on a liquidation basis are affected by significant uncertainties with respect to the realizability of amounts at which assets are presented and the amounts that creditors will agree to accept in settlement of the obligations due them. In such circumstances, the auditor should consider the need to modify his report because of the uncertainty as discussed in section 509.21—26 (see Appendix G) and should consider adding a sentence such as the following to the explanatory paragraph illustrated in the reports above.

"It is not presently determinable whether the amounts realizable from the disposition of the remaining assets or the amounts that creditors agree to accept in settlement of the obligations due them will differ materially from the amounts shown in the accompanying financial statements."

[Issue Date: December, 1984.]

[9.] Quantifying Departures From Generally Accepted Accounting Principles

[.39—.43] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

10. Updated Reports Resulting From the Retroactive Suspension of Earnings per Share and Segment Information Disclosure Requirements

.44 *Question*—An auditor's opinion on the 1977 financial statements of a nonpublic entity was modified because the financial statements did not comply with the requirements of APB Opinion No. 15, *Earnings per Share* [AC section E09], or FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise* [AC section S20], to disclose earnings per share or segment information. FASB Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises* [AC section S20.101—.103], issued in April 1978, suspended for nonpublic entities the requirements to disclose earnings per share and segment information. FASB Statement No. 21 [AC section S20] is retroactive to fiscal years beginning after December 15, 1976.

.45 Comparative financial statements for the years 1977 and 1978 will be issued. If the modification of the auditor's report on the 1977 financial statements is removed because of the retroactive suspension of the disclosure requirements, is it necessary for the auditor's updated report on the financial statements for 1977 that accompany the 1978 financial statements to explain the change in the auditor's opinion? Similarly, if the 1977 financial statements of a nonpublic entity are revised to remove disclosures of earnings per share and segment information, is it necessary for the auditor to refer to the revision in his report?

.46 *Interpretation*—Section 505, *Reports on Comparative Financial Statements*; paragraph .06 (see Appendix G), states that if an auditor previously modified his opinion on financial statements of a prior period because of a departure from generally accepted accounting principles and the financial statements are later restated to conform to generally accepted accounting principles, the auditor may express an unqualified opinion on the restated financial statements. Paragraph .77 also states that the auditor's report should indicate that the financial statements have been restated to conform to generally accepted accounting principles.

.47 In Statement No. 21 [AC section S20], the FASB retroactively suspended the disclosure requirements while they reconsider whether the disclosure of earnings per share and segment information are necessary for nonpublic enterprises. The requirement of section 505 [see Appendix G] to refer to the earlier nonconformity with those disclosure requirements is inconsistent with the intentions of the FASB contained in Statement No. 21 [AC section S20]. Thus, in the circumstances, the auditor would be justified in departing from the requirement of section 505 [See Appendix G] and need not refer to the restatement of the financial statements. The auditor may issue an unqualified opinion on the financial statements without referring to the earlier modified opinion and without referring to the previous lack of disclosure of earnings per share or segment information.

.48 Since the suspension of the disclosure requirements is retroactive, 1977 financial statements of nonpublic companies may be revised to remove earnings per share or segment information. It would not be necessary for the auditor to comment on such revisions in his report on comparative financial statements in the next year.

[Issue Date: March, 1979.]

11. Restating Financial Statements Reported on by a Predecessor Auditor

[.49—.50] [An Interpretation of section 315, *Communications Between Predecessor and Successor Auditors*, and section 505, *Reports on Comparative Financial Statements* (see Appendix G), entitled *Restating Financial Statements Reported on by a Predecessor Auditor*, can be found in section 9315.06—.07.]

[Issue Date: September, 1986.]

[The next page is 1959.]

AU Section 9543**Part of Examination Made by Other Auditors: Auditing Interpretations of AU Section 543****1. Specific Procedures Performed by the Other Auditor at the Principal Auditor's Request**

.01 *Question*—An independent auditor is examining the financial statements of a component¹ in accordance with generally accepted auditing standards and is issuing a report to his client that will also be used by another independent auditor who is acting as a principal auditor.² The principal auditor requests the other auditor to perform specific procedures, for example, to furnish or test amounts to be eliminated in consolidation, such as intercompany profits, or to read other information in documents containing audited financial statements. In those circumstances, who is responsible to determine the extent of the procedures to be performed?

.02 *Interpretation*—Section 543, *Part of Examination Made by Other Auditors*, paragraph .10, states that the principal auditor "should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements." Section 543.10c(iv) further states that those measures may include procedures such as ascertaining through communication with the other auditor "that a review will be made of matters affecting elimination of intercompany transactions and accounts."

.03 Thus, when the principal auditor requests the other auditor to perform procedures, he should provide specific instructions on procedures to be performed, materiality considerations for that purpose, and other information that may be necessary in the circumstances. The other auditor should perform the requested procedures in accordance with the principal auditor's instructions and, when requested to furnish a written report, should be guided by the provisions of section 622, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*.

[Issue Date: April, 1979.]

¹ For the purposes of this interpretation, the entities whose separate financial statements collectively comprise the consolidated or other financial statements are referred to as components.

² See section 543 for the definition of a principal auditor. For the purposes of this interpretation, the auditor whose work is used by a principal auditor is referred to as the other auditor.

2. Inquiries of the Principal Auditor by the Other Auditor

.04 *Question*—Section 543, *Part of Examination Made by Other Auditors*, gives guidance to a principal auditor on making inquiries of the other auditor. Section 543.03 also states that “the other auditor remains responsible for the performance of his own work and for his own report.” Should the other auditor also make inquiries of the principal auditor to fulfill that responsibility?

.05 *Interpretation*—Section 334, *Related Parties*, states that there may be inquiry of the principal auditor regarding related parties. In addition, before issuing his report, the other auditor should consider whether he should inquire of the principal auditor as to matters that may be significant to his own examination. [Reference changed August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 334.)

.06 The other auditor’s consideration of whether to make the inquiry should be based on factors such as his awareness that there are transactions or relationships which are unusual or complex between the component he is examining and the component the principal auditor is examining, or his knowledge that in the past matters relating to his examination have arisen that were known to the principal auditor but not to him.

.07 If the other auditor believes inquiry is appropriate he may furnish the principal auditor with a draft of the financial statements expected to be issued and of his report solely for the purpose of aiding the principal auditor to respond to the inquiry. The inquiry would concern transactions, adjustments, or other matters that have come to the principal auditor’s attention that he believes require adjustment to or disclosure in the financial statements of the component being examined by the other auditor. Also, the other auditor should inquire about any relevant limitation on the scope of the principal auditor’s examination.

[Issue Date: April, 1979.]

3. Form of Inquiries of the Principal Auditor Made by the Other Auditor

.08 *Question*—In those circumstances when the other auditor believes an inquiry of the principal auditor is appropriate, what form should the inquiry take and when should it be made?

.09 *Interpretation*—The other auditor’s inquiry ordinarily should be in writing. It should indicate whether the response should be in writing, and should specify the date as of which the principal auditor should respond. Ordinarily, that date should be near the anticipated date of the other auditor’s report. An example of a written inquiry from the other auditor is as follows:

“We are examining the financial statements of (name of client) as of (date) and for the (period of examination) for the purpose of expressing an opinion as to whether the finan-

cial statements present fairly the financial position, results of operations, and changes in financial position of (name of client) in conformity with generally accepted accounting principles.

A draft of the financial statements referred to above and a draft of our report are enclosed solely to aid you in responding to this inquiry. Please provide us (in writing) (orally) with the following information in connection with your current examination of the consolidated financial statements of (name of parent company) :

1. Transactions or other matters (including adjustments made during consolidation or contemplated at the date of your reply) that have come to your attention that you believe require adjustment to or disclosure in the financial statements of (name of client) being examined by us.

2. Any limitation on the scope of your examination that is related to the financial statements of (name of client) being examined by us, or that limits your ability to provide us with the information requested in this inquiry.

Please make your response as of a date near (expected date of the other auditor's report)."

.10 The principal auditor's reply will often be made as of a date when the principal auditor's examination is still in progress; however, the other auditor should expect that ordinarily the response should satisfy his need for information. However, there may be instances when the principal auditor's response explains that it is limited because his examination has not progressed to a point that enables him to provide a response that satisfies the other auditor's need for information. If the principal auditor's response is limited in that manner, the other auditor should consider whether to apply acceptable alternative procedures, delay the issuance of his report until the principal auditor can respond, or qualify his report for a limitation on the scope of his examination.

[Issue Date: April, 1979]

4. Form of Principal Auditor's Response to Inquiries from Other Auditors

.11 *Question*—An independent auditor acting in the capacity of a principal auditor may receive an inquiry from another independent auditor examining the financial statements of a component concerning transactions, adjustments, or limitations on his examination.³ What should be the form of the principal auditor's response?

³ See section 9543.04—.07, "Inquiries of the Principal Auditor by the Other Auditor," above.

.12 Interpretation—The principal auditor should respond promptly to the other auditor's inquiry, based on his examination, and if applicable, on his reading of the draft financial statements and report furnished by the other auditor. His response may be written or oral, as requested by the other auditor. However, the principal auditor's response ordinarily should be in writing if it contains information that may have a significant effect on the other auditor's examination.

.13 The principal auditor should identify the stage of completion of his audit as of the date of his reply. He should also indicate that no audit procedures were performed for the purpose of identifying matters that would not affect his examination and report, and therefore, not all the information requested would necessarily be revealed. If the principal auditor has been furnished with a draft of the financial statements being examined by the other auditor and a draft of his report, the principal auditor should state that he has read the draft only to aid him in making his reply.

.14 An example of a written response from the principal auditor is as follows:

"This letter is furnished to you in response to your request that we provide you with certain information in connection with your examination of the financial statements of (name of component), a (subsidiary, division, branch or investment) of Parent Company for the year ended (date).

We are in the process of performing an examination of the consolidated financial statements of Parent Company for the year ended (date) (but have not completed our work as of this date). The objective of our examination is to enable us to express an opinion on the consolidated financial statements of Parent Company and, accordingly, we have performed no procedures directed toward identifying matters that would not affect our examination or our report. However, solely for the purpose of responding to your inquiry, we have read the draft of the financial statements of (name of component) as of (date) and for the (period of examination) and the draft of your report on them, included with your inquiry dated (date of inquiry).

Based solely on the work we have performed (to date) in connection with our examination of the consolidated financial statements, which would not necessarily reveal all or any of the matters covered in your inquiry, we advise you that:

1. No transactions or other matters (including adjustments made during consolidation or contemplated at this date) have come to our attention that we believe require adjustment

to or disclosure in the financial statements of (name of component) being examined by you.

2. No limitation has been placed by Parent Company on the scope of our examination that, to our knowledge, is related to the financial statements (of name of component) being examined by you, that has limited our ability to provide you with the information requested in your inquiry."

[Issue Date: April, 1979.]

5. Procedures of the Principal Auditor

.15 *Question*—What steps, if any, should the principal auditor take in responding to an inquiry such as that described in section 9543.11?

.16 *Interpretation*—The principal auditor's response should ordinarily be made by the auditor with final responsibility for the engagement. He should take those steps that he considers reasonable under the circumstances to be informed of known matters pertinent to the other auditor's inquiry. For example, the auditor with final responsibility may inquire of principal assistants⁴ responsible for various aspects of the engagement or he may direct assistants to bring to his attention any significant matters of which they become aware during the examination. The principal auditor is not required to perform any procedures directed toward identifying matters that would not affect his examination or his report.

.17 If between the date of his response and the completion of his examination, the principal auditor becomes aware of information that he would have included in his response to the other auditor's inquiry had he been aware of it, the principal auditor should promptly communicate such information to the other auditor.⁵

[Issue Date: April, 1979.]

6. Application of Additional Procedures Concerning the Other Auditor's Examination

.18 *Question*—If a principal auditor decides not to make reference to the examination of another auditor, section 543 requires him to consider whether to apply procedures to obtain information about the adequacy of the other auditor's examination. In making a decision about (a) whether to apply one or more of the procedures listed in section 543.12 and (b), if applicable, the extent of those procedures, may the principal auditor consider his knowledge of the other auditor's compliance with quality control policies and procedures?

⁴See section 311, "Planning and Supervision" for the definition of "assistants."

⁵See section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," concerning procedures to be followed by the other auditor if he receives the information after the issuance of his report.

.19 *Interpretation*—Yes. The principal auditor's judgment about the extent of additional procedures, if any, to be applied in the circumstances may be affected by various factors including his knowledge of the other auditor's quality control policies and procedures that provide the other auditor with reasonable assurance of conformity with generally accepted auditing standards in his audit engagements.

.20 Other factors that the principal auditor may wish to consider in making that decision include his previous experience with the other auditor, the materiality of the portion of the financial statements examined by the other auditor, the control exercised by the principal auditor over the conduct of the other auditor's examination, and the results of the principal auditor's other procedures that may indicate whether additional evidential matter is necessary.

[Issue Date: December, 1981.]

AU Section 9544

Lack of Conformity With Generally Accepted Accounting Principles: Auditing Interpretations of AU Section 544

[1.] Auditors' Reports Solely for Purposes of Filing With Insurance Regulatory Agencies¹

[.01—.09] [Superseded October, 1979 by Interpretation No. 4, section 9621.15—.16.]

2. Reports in Filings Other Than With the Regulatory Agency on Financial Statements Prepared Using FHLBB Accounting Practices—Savings and Loan Associations

.10 *Question*—The Federal Home Loan Bank Board (FHLBB) recently adopted rules permitting member savings and loan associations (S&Ls), to defer gains and losses from the sale of mortgage assets—a departure from generally accepted accounting principles. Some S&Ls that adopt this accounting treatment in financial statements filed with the FHLBB may also decide to follow such accounting in financial statements to be distributed to others, including the shareholders. Under such circumstances, what is the proper method of reporting by the independent auditor?

.11 *Interpretation*—Section 544 provides that the first reporting standard is equally applicable to opinions on financial statements of regulated companies presented for purposes other than filings with their respective supervisory agencies and, accordingly, material departures from generally accepted accounting principles should be dealt with in the same manner followed by companies that are not regulated. Ordinarily this will require either a qualified or an adverse opinion on such statements. The S&L could avoid an opinion qualified or adverse for the departure from generally accepted accounting principles by not deferring gains and losses from sale of mortgage assets in its financial statements for purposes other than filings with the FHLBB. This is permitted by the FHLBB as long as the financial statements are reconciled to those filed with the FHLBB.

.12 Before 1981, an S&L would not have been permitted to defer gains and losses from the sale of mortgage assets. Consequently, in the first year that an S&L elects to defer such gains and losses, the auditor's opinion would be qualified both as to conformity with generally accepted accounting principles and as to consistency of application.

.13 Section 546.04 (see Appendix G) provides guidance to an auditor on the evaluation of a change in accounting principle. That section requires the auditor to satisfy himself that, among other things, management's justification for the change is reasonable. In this respect, a footnote to the section points out that Accounting Principles Board Opinion No. 20, paragraph 16

¹ Originally issued under the title "Auditors' Reports Solely for Purposes of Filing with Insurance Regulatory Agencies" (Journal of Accountancy, July '75, p. 69).

[AC section A06.112], states: "The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable." It would not be possible for an S&L to justify the adoption of the accounting policy of deferring gains and losses from the sale of mortgage assets in financial statements other than those prepared for filing with the FHLBB. Under these circumstances, the auditor should take exception to both the change having been made without reasonable justification and the particular accounting treatment of gains and losses from the sale of mortgage assets.

.14 The following example illustrates a report, for filings other than with the FHLBB, on financial statements that have been prepared using the FHLBB deferral method for only the most recent year where the effect of the deferral is material to net earnings or net worth:

"We have examined the statements of financial condition of XYZ Savings and Loan Association as of December 31, 19X2 and 19X1, and the related statements of operations, retained earnings (deficit), and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

"As further described in note X to the financial statements, during 19X2 the Association changed its method of accounting for gains and losses arising from the sale of certain mortgage assets from the current recognition of gains and losses to the deferral of such gains and losses as permitted by the Federal Home Loan Bank Board (FHLBB). In our opinion, this method of accounting is not in conformity with generally accepted accounting principles and the Association has not provided reasonable justification for making such a change in financial statements prepared for other than filing with the FHLBB. If these gains and losses were recognized currently, deferred charges would be decreased by \$....., and capital by \$..... as of December 31, 19X2, and the net loss would be increased by \$..... for the year then ended.

"In our opinion, except for the change in the accounting for gains and losses as described in the preceding paragraph, the financial statements referred to above present fairly the financial position of XYZ Savings and Loan Association as of December 31, 19X2 and 19X1, and the results of its operations and changes in its financial position for the years then ended in conformity with generally accepted accounting principles applied on a consistent basis."

If the auditor deems an adverse opinion to be appropriate in such circumstances, the opinion paragraph of his report with respect to the 19X2 financial statements would read as follows:

"Because of the significance of the effects of the matter described in the preceding paragraph, in our opinion the 19X2 financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of XYZ Savings and Loan Association as of December 31, 19X2, or the results of its operations and changes in its financial position for the year then ended."

Section 544 permits the auditor to express an opinion on whether the financial statements are presented in conformity with a basis of accounting prescribed or permitted by a regulatory agency in an additional paragraph to the report, but a report of this type is not mandatory. The additional paragraph, if used, should be carefully worded so as not to mitigate the intended emphasis of the departure from generally accepted accounting prin-

ciples. The report should not state or imply that the financial presentation under the accounting practices permitted by the FHLBB is an improved financial presentation. The following example illustrates an additional paragraph permitted under section 544.04:

"In our opinion, the 19X2 financial statements referred to above present fairly the assets, liabilities and retained earnings of XYZ Savings and Loan Association, at December 31, 19X2 and the income and expense and changes in its cash position for the year then ended, in conformity with accounting practices permitted by the FHLBB which, except for the change in accounting principle referred to above, have been applied on a basis consistent with that of the preceding year."

The substantial disposal of assets at a loss may be indicative of an S&L having liquidity and other pervasive financial problems. If, because of such factors, the auditor concludes that there is a substantial doubt about the entity's ability to continue in existence, he should consider the need to modify his report for the uncertainty. The following example illustrates additional explanatory paragraphs the auditor might include in his report if he concludes there is a material uncertainty that requires modification of his report (see section 340 in Appendix G):

"As further described in Note Y to the financial statements, the Association and the savings and loan industry in general are experiencing unfavorable operating results. Under its present asset-liability structure, continuing net losses from operations and declining net worth can be expected during periods of high interest rates. The Association must maintain total net worth in accordance with applicable requirements of the Federal Savings and Loan Insurance Corporation (FSLIC) and the FHLBB as further described in Note Z to the financial statements. Should the Association fail to satisfy prescribed net worth requirements, it would be subject to actions that might be taken by the FSLIC or FHLBB.

"The accompanying 19X2 financial statements were prepared in conformity with accounting principles which assume the continued existence of the Association. Accordingly, under that assumption, the accompanying 19X2 financial statements do not reflect adjustments that would be necessary should the Association be unable to continue in existence and, therefore, the recovery of non-cash assets may be at amounts substantially less than those presented in the accompanying 19X2 balance sheet."

In these circumstances, the auditor should, because of the uncertainty, appropriately modify his opinions on both conformity with generally accepted accounting principles and conformity with accounting practices permitted by the FHLBB.

[Issue Date: April, 1982.]

[The next page is 1975.]

AU Section 9550

Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AU Section 550

1. Reports by Management on Internal Accounting Control

.01 Question—Annual reports to shareholders may contain a report by management on its financial reporting responsibilities and related matters. A statement by management concerning the company's system of internal accounting control is a common subject in such reports.¹ What is the auditor's responsibility concerning such statement?

.02 Interpretation—Section 550, *Other Information in Documents Containing Audited Financial Statements*, makes clear that "the auditor has no obligation to corroborate other information contained in [such] a document." Under section 550, the auditor is required to read the report by management and consider whether it is materially inconsistent with information appearing in the financial statements and, as a result, he may become aware of a material misstatement of fact.²

.03 The auditor would often be familiar with matters covered in a management statement on internal accounting control and may become aware of information that causes him to believe that management's statement concerning internal accounting control contains a material misstatement of fact as described in section 550. If the auditor becomes aware of information in the report by management that conflicts with his knowledge or understanding of such matters, he should discuss the conflict with the client. If, after discussions with the client, the auditor concludes that a material misstatement of fact exists (for example, if he has in fact communicated to management a weakness in internal accounting control he considers material, as required by section 323 [see Appendix G], and management states that he has not³), the auditor should consider steps such as notifying senior management and the

¹For example, see *Conclusions and Recommendations of the Special Advisory Committee on Reports by Management* (AICPA) which states: "... the primary objective of the management report is to inform users of the various means, such as internal accounting control, by which management's responsibility for the financial statements is fulfilled." The Financial Executives Institute and the Securities and Exchange Commission also encourage the presentation of reports by management.

²Unless information on internal accounting control appears in the financial statements, which is not common, a management statement on internal accounting control could not be inconsistent with information appearing in financial statements.

³See the October 1978 auditing interpretation "Material Weaknesses in Accounting Control and the Foreign Corrupt Practices Act," (section 9317.03—.06) for guidance on what course of action should be followed by the auditor of a public entity when a material weakness in internal accounting control comes to his attention. In the context of an audit of financial statements, section 323 (see Appendix G) defines a material weakness as "a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that *errors or irregularities in amounts that would be material in relation to the financial statements being audited* may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions." (Emphasis added.) While section 323

board of directors or its audit committee in writing of his views concerning the information and consulting his legal counsel as to further appropriate action in the circumstances.

.04 An auditor can reasonably expect that any uncorrected weaknesses in internal accounting control that he considered material and thus had communicated to management, as required by section 323 (see Appendix G), will have been considered by management in developing its statement on internal accounting control. The auditor should recognize, however, that management's consideration of a weakness that the auditor considers material may be only one of several factors in management's assessment of the company's system of internal accounting control. For example, management, after evaluating the costs of correction in relation to the expected benefits to be derived, may have concluded that corrective action for such a weakness is not practicable. The auditor would not be expected to independently test and form an opinion on management's conclusion in this highly subjective area. However, the auditor should consider the factors underlying management's assessment and if the auditor believes that management's statement on internal accounting control fails to disclose a fact needed to complete the statement in order for the statement made not to be a material misstatement, he should consider the steps described in the preceding paragraph.

.05 The management report may refer to the independent auditor. However, the auditor should consider whether management's statement uses his name in such a way as to indicate or imply that his involvement is greater than is supported by the facts. For example, even though section 323 (see Appendix G) permits an auditor to report to management that he has not become aware of any material weaknesses during his examination, management should be discouraged from stating in a public report that the auditor has not identified any material weaknesses in internal accounting control in connection with his audit of the financial statements.⁴ The foundation for such a statement in a public report could be misunderstood because it is not practicable for a report by management to adequately describe the varying extent of auditor's studies and evaluations of internal accounting control. Further, the fact that an audit has not disclosed any weaknesses the auditor considers material does not necessarily mean none exists since the auditor is not required under generally accepted auditing standards to evaluate each control or to identify every material weakness.

.06 Reports by management may also discuss additional matters that management considers relevant to its operations, such as administrative controls. The auditor generally would have less familiarity with such matters than he has with matters of internal accounting control. Nevertheless, when an accountant believes there is a material misstatement of fact with respect to such information, he should discuss the matter with the client and consider whether any further action is needed in accordance with section 550.

[Issue Date: January, 1981.]

[The next page is 1991.]

(Footnote Continued)

(see Appendix G) provides that the auditor may wish to communicate immaterial weaknesses in internal accounting control, he is not required to do so.

⁴ However, when the study and evaluation made as part of the audit is sufficient for expressing an opinion on the system, management may state that the auditor has not identified any material weaknesses. In these circumstances, to reduce the risk of misunderstanding, management should be encouraged to include in the document the auditor's report expressing an opinion on the system (see section 642.48, footnote 8 in Appendix G) since it describes the objectives and limitations of internal accounting control and of accountants' evaluations of it or alternatively, the management report could include these descriptions.

AU Section 9621

Special Reports: Auditing Interpretations of AU Section 621

[1.] Auditor's Report Under Employee Retirement Income Security Act of 1974

[.01—.08] [Withdrawn February, 1983.*]

2. Reports on Elements, Accounts, or Items of a Financial Statement That Are Presented in Conformity with GAAP

.09 *Question*—Paragraph 10 of section 621, *Special Reports*, states in part: "since specified elements, accounts, or items of a financial statement are not considered to be a financial statement, the first standard of reporting does not apply." If a specified element, account, or item of a financial statement is intended to be presented in conformity with generally accepted accounting principles rather than, for example, in accordance with the provisions of a contract, law, or government regulation, should the independent auditor express an opinion that the element, account, or item is in conformity with generally accepted accounting principles (GAAP)?

.10 *Interpretation*—Yes. Section 621.13 requires the independent auditor's report on one or more specified elements, accounts, or items of a financial statement to identify the basis on which the specified elements, accounts, or items are presented. Section 621.10 states that "the first standard of reporting does not apply" because, in engagements of the type discussed in sections 621.09—.14 ** and 622,** specified elements, accounts, or items of a financial statement are not required to be presented in conformity with GAAP. Section 621.10 also states: "the second standard of reporting as to consistency is applicable *if the elements . . . on which the auditor is to express an opinion are prepared in accordance with generally accepted accounting principles*" (emphasis added). Hence, GAAP is an appropriate basis for presenting an element, account, or item of a financial statement under the provisions of sections 621 and 622.**

[Issue Date: July, 1978.]

* See Audit and Accounting Guide, *Audits of Employee Benefit Plans*, February, 1983.

** References changed by issuance of SAS No. 35.

[3.] Compliance with the Foreign Corrupt Practices Act of 1977

[11—14] [Transferred to AU section 9642.]

[4.] Reports on Engagements Solely to Meet State Regulatory Examination Requirements

[15—16] [Deleted April, 1981 by SAS No. 35.] (See section 622.)

5. Financial Statements Prepared in Accordance with Accounting Practices Specified in an Agreement

.17 *Question*—An agreement may specify accounting practices to be used in the preparation of financial statements that depart from generally accepted accounting principles. A loan agreement, for example, may require the borrower to prepare consolidated financial statements in which investments in certain unconsolidated subsidiaries are presented on the equity method of accounting and investments in other unconsolidated subsidiaries are presented at cost (a basis that is not in conformity with generally accepted accounting principles in the borrower's circumstances). Also, an acquisition agreement may require the financial statements of the entity being acquired (or a segment of it) to be prepared in conformity with generally accepted accounting principles except for certain assets, such as receivables, inventories, and properties for which a valuation basis is specified in the agreement.

.18 Are such bases of accounting a "comprehensive basis of accounting other than generally accepted accounting principles" as discussed in section 621.04d, *Special Reports*, that is, "a definite set of criteria having substantial support that is applied to all material items appearing in financial statements . . .?"

.19 *Interpretation*—No. A basis of accounting specified in an agreement, as discussed above, is not a comprehensive basis of accounting as contemplated by section 621.04d, because it would not meet the requirement of being "criteria having substantial support" even though the criteria are definite.

.20 *Question*—In the circumstances described above would it be appropriate for the auditor to report in a manner similar to section 544.04 applicable to regulated companies, which states that "the auditor should use the standard form of report . . ., modified as appropriate . . . because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting."?

.21 *Interpretation*—Yes, provided the auditor modifies his report as to the conformity of the special-purpose financial statements with

➡➡➡ The next page is 1995. ⬅⬅⬅

generally accepted accounting principles, it would be appropriate for him to express in an additional paragraph of his report an opinion on whether the statements are presented fairly on the basis of accounting specified in an agreement such as those described above. In those circumstances, the basis of accounting and the reason for the basis should be described in the auditor's report and in a note to the financial statements. Also, if financial statements have previously been issued in the same special circumstances, the auditor's report should indicate whether in his opinion the disclosed basis of accounting used has been applied in a manner consistent with that of the preceding period.

.22 As discussed in section 509.42 (see Appendix G), when the auditor expresses an adverse opinion, he should disclose in a separate paragraph of his report the principal monetary effects of the subject matter on the entity's financial position, results of operations, and changes in financial position, if reasonably determinable. If the financial statements are presented in conformity with a basis such as those described above, the requirement that the principal effects of the departures from generally accepted accounting principles be disclosed may also be satisfied by referring to a note to the financial statements that discloses such effects or by referring to coexisting audited financial statements of the same entity prepared in conformity with generally accepted accounting principles as of (and, when applicable, for the period ended on) the same date as the special-purpose financial statements.

.23 Coexisting financial statements prepared by the entity in conformity with generally accepted accounting principles is not a requirement for the auditor to be able to report on the special-purpose financial statements. When the financial statements have been prepared on a basis specified in an agreement and the effects of departures from generally accepted accounting principles have not been determined by the company, the auditor may be able to reasonably estimate whether such effects would be sufficiently material to require issuance of a qualified opinion, or would be so material as to require issuance of an adverse opinion. If the auditor is not able to reasonably estimate the effects of departures, he should disclaim an opinion regarding conformity with generally accepted accounting principles. Such a disclaimer of opinion, however, would not preclude an auditor from expressing an opinion regarding whether the special-purpose financial statements are presented fairly in conformity with a basis of accounting such as those described above.

.24 The auditor should consider the need to include a paragraph that describes and indicates (or refers to a note that describes and indicates) the source of any significant interpretations made by the

client regarding provisions of the agreement relating to the financial statements.

.25 The following examples illustrate reports on special-purpose financial statements that have been prepared pursuant to a loan agreement and an acquisition agreement and the different ways the effects of departures from generally accepted accounting principles may be disclosed.

*Report on Financial Statements Prepared Pursuant to a Loan Agreement
(Disclosure of Effects of Departures from Generally Accepted
Accounting Principles by Referring to a Note to the Financial State-
ments)*

We have examined the special-purpose balance sheet of ABC Company as of December 31, 19X1, and the related special-purpose statements of income, retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The accompanying special-purpose financial statements have been prepared for the purpose of complying with, and on the basis of accounting practices specified in, Section 4 of a loan agreement between DEF Bank and the Company dated (date). These practices differ, as described in Note X, from generally accepted accounting principles. Accordingly, the financial statements are not intended to present and, in our opinion, do not present fairly the financial position, results of operations and changes in financial position of ABC Company in conformity with generally accepted accounting principles.

In our opinion, however, the accompanying special-purpose financial statements of ABC Company are presented fairly on the basis of accounting described in Note X, which basis has been applied in a manner consistent with that of the preceding year.

*Report on Financial Statements Prepared Pursuant to a Loan Agreement
(Disclosure of Effects of Departures from Generally Accepted
Accounting Principles by Referring to Coexisting Audited Financial
Statements)*

We have examined the special-purpose balance sheet of ABC Company as of December 31, 19X1, and the related special-purpose statements of income, retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The accompanying special-purpose financial statements have been prepared for the purpose of complying with, and on the basis of

accounting practices specified in, section 4 of a loan agreement between DEF Bank and the Company dated (date). These practices differ, as described in Note X, from generally accepted accounting principles. Accordingly, the financial statements are not intended to present and, in our opinion, do not present fairly the financial position, results of operations and changes in financial position of ABC Company in conformity with generally accepted accounting principles. The monetary effects of the departures from generally accepted accounting principles can be determined by comparing the special-purpose financial statements with the financial statements of ABC Company for the year ended December 31, 19X1, prepared in conformity with generally accepted accounting principles on which we issued our report dated February 14, 19X2.

In our opinion, however, the accompanying special purpose financial statements of ABC Company are presented fairly on the basis of accounting described in Note X, which basis has been applied in a manner consistent with that of the preceding year.

Report on Financial Statements Prepared Pursuant to an Acquisition Agreement (Effects of Departures from Generally Accepted Accounting Principles Have Not Been Determined)

We have examined the special-purpose balance sheet of ABC Company as of June 30, 19XX, and the related special-purpose statements of income, retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The accompanying special-purpose financial statements have been prepared for the purpose of complying with, and on the basis of accounting practices specified in, an acquisition agreement dated May 15, 19XX, between ABC Company and DEF Company. These practices differ, as described in Note X, from generally accepted accounting principles; the monetary effects on the accompanying financial statements of such differences have not been determined. Accordingly, we are unable to and do not express an opinion on whether the accompanying special-purpose financial statements fairly present the financial position, results of operations and changes in financial position of ABC Company in conformity with generally accepted accounting principles.

In our opinion, however, the accompanying special-purpose financial statements of ABC Company are presented fairly on the basis of accounting described in Note X.

[Issue Date: February, 1980.]

6. Reporting on Special-Purpose Financial Presentations

.26 *Question*—An auditor may be requested to report on special-purpose financial presentations that do not constitute a complete presentation of historical financial position or results of operations of an entity. For example, a governmental agency may require a schedule of gross income and certain expenses of an entity's real estate operation in which income and expenses are measured in conformity with generally accepted accounting principles, but expenses are defined to exclude certain items such as interest, depreciation, and income taxes.³ Such a schedule may also present the excess of gross income over defined expenses. Also, a buy-sell agreement may specify a schedule of certain assets and liabilities of the entity, representing the assets to be sold and liabilities to be transferred pursuant to the buy-sell agreement, in which the assets and liabilities are measured in conformity with generally accepted accounting principles, but do not constitute substantially all of the assets and liabilities of the entity.

.27 How should the auditor report in such circumstances?

.28 *Interpretation*—The term financial statement is defined in section 621.02, *Special Reports*. That paragraph includes a list of financial presentations which should be considered by an independent auditor to be a financial statement for reporting purposes. These include, among others, a statement of revenue and expenses, a statement of assets and liabilities that does not include owners' equity accounts, and a summary of operations. The concept of specified elements, accounts, or items of a financial statement in section 621, on the other hand, refers to accounting information that is part of but significantly less than a financial statement. The financial presentations described above generally should be regarded as financial statements.

.29 Thus, when an auditor is requested to examine and express an opinion on such special-purpose financial presentations, the measurement of materiality should be related to the presentation taken as a whole.⁴ The auditor's report should indicate his opinion on the fairness of the presentation of the information (for example, net assets sold, or income before depreciation, interest, and taxes) in conformity with generally accepted accounting principles.

³ Examples of such governmental agency requirements include (a) Regulation S-X of the Securities and Exchange Commission which requires registrants to present for certain significant real estate properties acquired, audited income statements that exclude items not comparable to the proposed future operations of such properties and (b) certain applications to municipalities in connection with the assessed valuation of rental properties. [Modified, October, 1980, by Auditing Standards Board.]

⁴ See section 312.

.30 To avoid any implication that the special-purpose financial statement being reported on is intended to present financial position, results of operations, or changes in financial position, the auditor's report should clearly state what the statement is intended to represent and the auditor should be satisfied that the statement is suitably titled. The extent to which the special-purpose financial statement differs from a complete financial statement should be limited to that necessary to meet the special purpose for which the presentation was prepared and, accordingly, in all other respects, including matters of informative disclosures, generally accepted accounting principles should be followed.

.31 The following examples illustrate reports expressing an opinion on such special-purpose financial statements:

Report on a Schedule of Gross Income and Certain Expenses

We have examined the accompanying Historical Summary of Gross Income and Direct Operating Expenses of ABC Apartments, City, State, for each of the three years in the period ended December 31, 19XX. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The accompanying historical summary was prepared for the purpose of complying with the rules and regulations of the Securities and Exchange Commission (for inclusion in the registration statement on Form S-11 of DEF Corporation) and excludes certain material expenses, described in Note X, that would not be comparable to those resulting from the proposed future operations of the property.

In our opinion, the historical summary referred to above presents fairly the gross income and direct operating expenses described in Note X of ABC Apartments for each of the three years in the period ended December 31, 19XX, in conformity with generally accepted accounting principles applied on a consistent basis.

Report on a Statement of Assets Sold and Liabilities Transferred

We have examined the statement of net assets of ABC Company as of June 8, 19XX, sold pursuant to the Purchase Agreement as described in Note X, between ABC Company and XYZ Corporation dated May 8, 19XX. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statement presents fairly the net assets of ABC Company as of June 8, 19XX, sold pursuant to the

purchase agreement referred to above, in conformity with generally accepted accounting principles.

[Issue Date: February, 1980; modified: October, 1980.]

[7.] Understanding of Agreed-Upon Procedures

[.32—.33] [Deleted April, 1981 by SAS No. 35.] (See section 622.)

8. Adequacy of Disclosure in Financial Statements Prepared on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles

.34 *Question*—Section 621.05, *Special Reports*, footnote 3, states that “In reporting on financial statements on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used.” Also, section 621.02 states that generally accepted auditing standards apply when the auditor examines and reports on such financial statements. Thus, in accordance with the third standard of reporting, “informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.”

.35 However, the disclosure requirements under other comprehensive bases of accounting (for example, accounting practices prescribed by a regulatory agency, income tax basis, or cash basis) are not as well defined in accounting literature as they are under generally accepted accounting principles. How should the auditor evaluate whether informative disclosures in financial statements prepared on an other comprehensive basis of accounting are appropriate?

.36 *Interpretation*—The criteria the auditor should apply are essentially the same as those applicable to financial statements prepared in conformity with generally accepted accounting principles. These criteria are discussed in section 411.04, *The Meaning of “Present Fairly in Conformity with Generally Accepted Accounting Principles” in the Independent Auditor’s Report*. The auditor’s opinion should be based on his judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation.

.37 Whenever an auditor reports on financial statements prepared on an other comprehensive basis of accounting, a note to the financial statements that states the basis of presentation and a description of how the basis of presentation differs from generally accepted accounting principles is required by section 621.05.

.38 In addition, when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, the same degree of informative disclosures is generally appropriate. For example, financial statements prepared on an income tax basis or a modified cash basis of accounting usually reflect depreciation, long-term debt and owners' equity. Thus, the informative disclosures for depreciation, long-term debt and owners' equity in such financial statements should be comparable to those in financial statements prepared in conformity with generally accepted accounting principles.

.39 To comply with the third standard of reporting, the auditor should also consider other matters that could reasonably be expected to materially affect the understanding of the financial statements, independent of the basis of accounting used, such as (a) contingencies and uncertainties, (b) changes in accounting principles or estimates, (c) related party transactions, (d) restrictions on assets and owners' equity, and (e) subsequent events.

[Issue Date: February, 1980.]

9. Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves

.40 *Question*—The instructions to the statutory annual statement to be filed by property and liability insurance companies with state regulatory agencies include the following:

If a company is required by its domiciliary commissioner, there is to be submitted to the commissioner as an addendum to the Annual Statement by April 1 of the subsequent year a statement of a qualified loss reserve specialist setting forth his or her opinion relating to loss and loss adjustment expense reserves.

The term "qualified loss reserve specialist" includes an independent auditor who has competency in loss reserve evaluation.

.41 If an independent auditor who has made an examination of the insurance company's financial statements in accordance with generally accepted auditing standards is engaged to express a separate opinion on the company's loss and loss adjustment expense reserves for the purpose of compliance with the above instruction, what form of report should be used by the independent auditor?

.42 *Interpretation*—Section 621.10—.14 provides guidance on auditors' reports expressing an opinion on one or more specified elements, accounts, or items of a financial statement. Following are illustrations of the auditor's report expressing an opinion on a company's loss and

loss adjustment expense reserves and the schedule of liabilities for losses and loss adjustment expenses that would accompany the report.⁶

Illustrative report

Board of Directors

X Insurance Company

We are members of the American Institute of Certified Public Accountants (AICPA) and are the independent public accountants of X Insurance Company. We acknowledge our responsibility under the AICPA's Code of Professional Ethics to undertake only those engagements which we can complete with professional competence.

We have examined the financial statements prepared in conformity with generally accepted accounting principles [or prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of] of X Insurance Company as of December 31, 19X0, and have issued our report thereon dated March 1, 19X1. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. In the course of our examination, we have examined the estimated liabilities for unpaid losses and unpaid loss adjustment expenses of X Insurance Company as of December 31, 19X0, as set forth in the accompanying schedule including consideration of the assumptions and methods relating to the estimation of such liabilities.

In our opinion, the accompanying schedule presents fairly the estimated unpaid losses and unpaid loss adjustment expenses of X Insurance Company that could be reasonably estimated at December 31, 19X0, in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of on a basis consistent with that of the preceding year.

This report is intended solely for filing with regulatory agencies and is not intended for any other purpose.

Signature
Date

⁶ If a significant period of time has elapsed between the date of the independent auditor's report on the financial statements and the date he is reporting on the loss and loss adjustment expense reserves, the auditor may wish to include the following paragraph in his special report: Because we have not examined any financial statements of X Insurance Company as of any date or for any period subsequent to December 31, 19X0, we have no knowledge of the effects, if any, on the liability for unpaid losses and unpaid loss adjustment expenses of events that may have occurred subsequent to the date of our examination.

X Insurance Company
Schedule of Liabilities for Losses
and Loss Adjustment Expenses
December 31, 19X0

Liability for losses	\$xx.xxx.xxx
Liability for loss adjustment expenses	x.xxx.xxx
	<hr/>
Total	\$xx.xxx.xxx
	<hr/> <hr/>

Note 1—Basis of presentation

The above schedule has been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of (Significant differences between statutory practices and generally accepted accounting principles for the calculation of the above amounts should be described but the monetary effect of any such differences need not be stated.)

Losses and loss adjustment expenses are provided for when incurred in accordance with the applicable requirements of the insurance laws [and/or regulations] of the State of Such provisions include (1) individual case estimates for reported losses, (2) estimates received from other insurers with respect to reinsurance assumed, (3) estimates for unreported losses based on past experience modified for current trends, and (4) estimates of expenses for investigating and settling claims.

Note 2—Reinsurance

The Company reinsures certain portions of its liability insurance coverages to limit the amount of loss on individual claims and purchases catastrophe insurance to protect against aggregate single occurrence losses. Certain portions of property insurance are reinsured on a quota share basis.

The liability for losses and the liability for loss adjustment expenses were reduced by \$xxx,xxx and \$xxx,xxx, respectively, for reinsurance ceded to other companies.

Contingent liability exists with respect to reinsurance which would become an actual liability in the event the reinsuring companies, or any of them, might be unable to meet their obligations to the Company under existing reinsurance agreements.

.43 *Question*—The instructions to the statutory annual statement also include the following:

If there has been any material change in the assumptions and/or methods from those previously employed, that change should be described in the statement of opinion by inserting a phrase such as:

A material change in assumptions (and/or methods) was made during the past year, but such change accords with accepted loss reserving standards.

A brief description of the change should follow.

.44 In what circumstances is it appropriate for the independent auditor to modify his special report on loss and loss adjustment expense reserves for material changes in assumptions and/or methods?

.45 *Interpretation*—Section 420.06 states that changes in accounting principles and methods of applying them affect consistency and require recognition in the auditor's opinion on the audited financial statements as to consistency. Section 621.13 states that, if applicable, any modifications of the auditor's standard report on the related financial statements should be indicated in the special report on an element, account, or item of a financial statement.

.46 Section 420.12 states that a change in accounting estimate is not a change affecting consistency requiring recognition in the auditor's report. However, such changes in estimates that are disclosed in the financial statements on which the auditor has reported should also be disclosed in the notes to the schedule of liabilities for unpaid losses and unpaid loss adjustment expenses accompanying the auditor's special report. (See APB Opinion No. 20, *Accounting Changes*, paragraph 33 [AC section A06.132].)

[Issue Date: May, 1981.]

10. Reports on the Financial Statements Included in Internal Revenue Form 990, "Return of Organizations Exempt from Income Tax"

.47 *Question*—Internal Revenue Form 990, "Return of Organizations Exempt from Income Tax," may be used as a uniform annual report by charitable organizations in some states for reporting to both state and federal governments. Many states require an auditor's opinion on whether the financial statements included in the report¹ are presented fairly in conformity with generally accepted accounting principles. Ordinarily, financial statements included in a Form 990 used by a charitable organization as a uniform annual report may be

¹ As used in this interpretation, the report refers to a Form 990 used as a uniform annual report by a charitable organization in a filing with a government agency.

expected to contain certain material departures from the accounting principles in the AICPA industry audit guides, "Audits of Colleges and Universities," "Hospital Audit Guide," "Audits of Voluntary Health and Welfare Organizations," and AICPA Statement of Position 78-10, "Accounting Principles and Reporting Practices for Certain Nonprofit Organizations."

.48 In most states the report is used primarily to satisfy statutory requirements, but regulatory authorities make the financial statements and the accompanying auditor's report a matter of public record. In some situations, however, there may be public distribution of the report. What should be the form of the auditor's report in each of the above situations?

.49 *Interpretation*—In both situations, the auditor should first consider whether the financial statements (including appropriate notes to financial statements) are in conformity with generally accepted accounting principles. If they are, the auditor can express an unqualified opinion.

.50 If the financial statements are not in conformity with generally accepted accounting principles, the auditor should consider the distribution of the report to determine whether it is appropriate to issue a special report (as illustrated in section 621, "Special Reports," paragraph .08, for reporting on financial statements prepared in accordance with the requirements or financial reporting provisions of a government regulatory agency).

.51 Section 621 permits this type of special report, only if the financial statements are intended solely for filing with a regulatory agency or if additional distribution is recognized as appropriate by an AICPA accounting or audit guide or auditing interpretation. However, section 621 (as amended by section 622) makes this form of reporting appropriate, even though by law or regulation the accountant's report may be made a matter of public record.²

.52 The following example illustrates a report expressing an opinion on such special purpose financial statements:

"We have examined the balance sheet (Part V) of
as of, and the related statement of support, revenue
and expenses and changes in fund balances (Part I) and state-
ment of functional expenses (Part II) for the year then ended

² *Public record*, for purposes of auditors' reports in state filings on various Forms 990 dealing with exempt organizations, includes circumstances in which specific requests must be made by the public to obtain access to or copies of the report, notwithstanding the fact that some states may advertise or require the exempt organization to advertise the availability of Form 990. In contrast, *public distribution*, for purposes of auditors' reports in state filings on various Forms 990 dealing with exempt organizations, includes circumstances in which the regulatory agency or the exempt organization, either because of regulatory requirements or voluntarily, distributes copies of Form 990 to contributors or others without receiving a specific request for such distribution.

included in the accompanying Internal Revenue Service Form 990. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

"As described in Note X, the Form 990 financial statements have been prepared in the format and following the instructions of the Internal Revenue Service and the Office of State. These instructions prescribe practices that differ in some respects from generally accepted accounting principles. Accordingly, the accompanying Form 990 financial statements are not intended to present financial position, results of operations, or changes in financial position in conformity with generally accepted accounting principles. This report is intended solely for filing with regulatory agencies and is not intended for any other purpose.

"In our opinion, the financial statements referred to above present fairly the assets, liabilities and fund balances of as of and its support, revenue and expenses and changes in fund balances for the year then ended on the basis of accounting described in Note X, which basis has been applied in a manner consistent with that of the preceding year.³

"Our examination was made for the purpose of forming an opinion on the above financial statements taken as a whole. The accompanying information on pages to is presented for purposes of additional analysis and is not a required part of the above financial statements. Such information, except for that portion marked 'unaudited,' on which we express no opinion, has been subjected to the auditing procedures applied in the examination of the above financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the above financial statements taken as a whole."

.53 If there is public distribution⁴ of the report, because the law requires it or otherwise (copies of Form 990 are distributed to contributors or others without receiving a specific request for such distribution) and the financial statements included in it are not in conformity with generally accepted accounting principles, a special report (as illustrated in section 621.08) is not appropriate. In such

³ Auditors should give particular consideration to the consistency standard the first year Form 990 is used for such financial reporting purposes.

⁴ Auditors should consider whether there is a public distribution requirement by reference to the relevant state law. However, at this time (April 1982), most state laws do not contain a public distribution requirement and a special report is ordinarily appropriate. For example, the laws of New York, New Jersey and Connecticut do not presently require public distribution as defined by this interpretation.

cases, the auditor should express a qualified or adverse opinion and disclose the effects on the financial statements of the departures from generally accepted accounting principles if the effects are reasonably determinable. If the effects are not reasonably determinable, the report should so state.

.54 Uniform generally accepted accounting principles for non-profit organizations, including those filing Form 990, are still in the developmental stage. Therefore, auditors should recognize that the use of a special purpose report on Form 990 is only an interim solution until the reporting issues have been resolved by the Financial Accounting Standards Board.

[Issue Date: July, 1982.]

»»»→ *The next page is 1997.* ←«««

AU Section 9634

Letters for Underwriters: Auditing Interpretations of AU Section 634

1. Letters to Directors Relating to Annual Reports on Form 10-K *

.01 *Question*—Annual reports to the Securities and Exchange Commission (SEC) on Form 10-K must be signed by at least a majority of the registrant's board of directors. In reviewing the Form 10-K, directors may seek the involvement of the registrant's independent auditors and other professionals.

.02 What types of services could the auditor perform at the request of the board of directors in connection with the Form 10-K? For example, is it permissible for an auditor to comment in the form of negative assurance concerning the compliance of the registrant's Form 10-K with the requirements of the various SEC rules and regulations?¹

.03 *Interpretation*—The auditor can express an opinion to the board of directors on whether the financial statements and schedules examined by him comply as to form with the applicable accounting requirements of the Securities Exchange Act of 1934 and the published rules and regulations thereunder.² Except with respect to requirements for financial statements and schedules, the question of what constitutes appropriate information for compliance with the requirements of a particular item of Form 10-K generally involves matters of legal interpretation not within the professional capabilities of independent auditors. Accordingly, the auditor should not express negative assurance concerning the compliance with SEC requirements of information not covered by the auditor's report.

.04 The auditor may affirm to the board of directors that under generally accepted auditing standards the auditor is required to read

* [Formerly section 9630.11—.19, as modified by issuance of Statement on Auditing Standards No. 38, *Letters for Underwriters*, April, 1981 (superseded). Formerly section 9631.01—.09, changed to section 9634.01—.09 by issuance of Statement on Auditing Standards No. 49, *Letters for Underwriters*, September, 1984.] (See section 634.)

¹ Negative assurance consists of a statement by auditors to the effect that nothing came to their attention as a result of specified procedures that caused them to believe that specified matters do not meet a specified standard.

² The auditor should not provide any assurance on compliance with the provisions of the Securities Exchange Act of 1934 regarding internal accounting control. See the October 1978 auditing interpretation, "Compliance with the Foreign Corrupt Practices Act of 1977" (AU section 9642.10—.13).

the information in addition to audited financial statements contained in the Form 10-K, for the purpose of considering whether such information may be materially inconsistent with information appearing in the financial statements. (See section 550.) However, the report to the board of directors should state that the auditor has no obligation to perform any procedures to corroborate such information.

.05 In addition, the auditor could perform at the request of the board of directors specified procedures and report his findings concerning various information contained in the Form 10-K such as tables, statistics and other financial information provided there is a clear understanding with the Board as to the nature, extent and limitations of the procedures to be performed and as to the kind of report to be issued. The guidance provided in section 634 is intended primarily for the auditor issuing a letter to underwriters in connection with a registration statement filed under the Securities Act of 1933. However, much of the guidance in paragraphs .40 through .45 of section 634 would also be applicable when the auditor is asked to furnish a letter to the board of directors in connection with the filing of Form 10-K under the Securities Exchange Act of 1934.³ [References changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

.06 The types of information on which the auditor may comment are described in section 634.41. In general, the auditor should comment only on information that has been obtained from financial statements or accounting records subject to the client's internal accounting controls, or derived directly from such reports by analysis or computation. The comments should be made in the form of descriptions of the procedures followed and of the auditor's findings, ordinarily expressed in terms of agreement between items compared. [Reference changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

.07 The auditor should not comment on matters that are primarily subjective or judgmental in nature such as those included in Item 7 of Form 10-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations." For example, changes between periods in gross profit ratios may be caused by factors that are not necessarily within the expertise of auditors. In addition, the discussion may contain certain forward-looking information for which

³ Section 634.02 states in part: "Accountants will normally be willing to assist the underwriter, but the assistance accountants can provide by way of comfort letters is subject to limitations. One limitation is that an independent accountant can properly comment in his professional capacity only on matters to which his professional expertise is substantially relevant." [Reference changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

it generally would be inappropriate for the auditor to provide any form of assurance. However, the auditor can comment on specific changes in comparative amounts that are included in management's discussion if the amounts used to compute such changes are obtained from the financial statements or accounting records as discussed above, but cannot comment with respect to the appropriateness of the explanations.

.08 There are no criteria by which to measure the sufficiency of the procedures performed by the auditor for the directors' purposes. Ordinarily, the auditor should discuss with the directors or the audit committee the procedures to be followed and may suggest procedures that might be meaningful in the circumstances. However, the auditor should clearly indicate to the board of directors that the auditor cannot make any representations as to whether the agreed-upon procedures are sufficient for the directors' purposes.

.09 It should not ordinarily be necessary for the auditor to reaffirm his independence to the board of directors. If such a representation is requested, however, the auditor may include in his letter a paragraph as follows:

[We are independent certified public accountants with respect to the Company within the meaning of the Securities Exchange Act of 1934 and the applicable published rules and regulations thereunder.]

[Issue Date: April, 1981; modified: May, 1981.]

2. Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters

.10 *Question*—Section 634, *Letters for Underwriters*, paragraph .24, states that unaudited condensed interim financial statements for a period ending after the latest financial statements included in a registration statement should be attached to a comfort letter when an accountant gives negative assurance on the unaudited condensed interim financial statements. The negative assurance referred to in paragraph .24 could relate to negative assurance that the unaudited condensed interim financial statements are in conformity with generally accepted accounting principles or that these financial statements are stated on a basis substantially consistent with the audited financial statements included in the registration statement. It could also relate to negative assurance regarding changes in specified financial statement items derived from interim financial statements not included in the registration statement when such specified financial statement items are compared with similar information in the corresponding-period prior-year financial statements. Does the negative assurance in paragraph .24 relate to all of these situations or only specific situations?

.11 *Interpretation*—In the situations described in section 634.24, negative assurance relates to negative assurance that unaudited condensed interim financial statements for a period ending after the latest financial statements included in the registration statement, including financial statements that underlie capsule information, are in conformity with generally accepted accounting principles or are stated on a basis substantially consistent with the audited financial statements included in the registration statement. The unaudited condensed interim financial statements referred to in these situations should be attached to the comfort letter.

.12 Section 634.24 does not relate to negative assurance regarding changes in specified financial statement items. Section 634, paragraphs .25 through .31 provide guidance in these situations.

[Issue Date : July, 1986.]

➡ *The next page is 2011.* ←

AU Section 9642

Reporting on Internal Accounting Control: Auditing Interpretations of AU Section 642

1. Pre-Award Surveys

.01 Question—If an independent auditor is engaged to perform a pre-award survey in connection with a government grant program, how should he report on the design of the system of internal accounting control, including incorporation of comments on the agency's criteria?

.02 Interpretation—The report illustrated in section 642.59 should be modified in the following way to recognize the circumstances of a pre-award survey:

We understand that (applicant) has applied for a grant of \$...... from (agency) for the period from through for use in accordance with the (title or description of program). We have made a study of the design of those internal accounting control and administrative control procedures of (applicant) that we considered relevant to the criteria established by (agency) as set forth in section of its Audit Guide issued (date). Since our study related to procedures (applicant) proposes to follow if the grant is awarded, it did not include tests of compliance with such procedures. Our study did not constitute an audit of any financial statements prepared by (applicant).

The management of (applicant) is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. We understand that the objective of those administrative control procedures comprehended in the (agency's) criteria is to provide similar assurance as to compliance with its related requirements.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

We understand that procedures in conformity with the criteria referred to in the first paragraph of this report are considered by the (agency) to be adequate for its purposes in accordance with the (name

of act) and related regulations, and that procedures not in conformity therewith indicate some inadequacy for such purposes. Based on this understanding and on our study, we believe the (applicant's) procedures would be adequate for the agency's purposes, assuming satisfactory compliance, except for the conditions described (reference to appropriate section of report) which we believe would be material weaknesses in relation to the grant to which this report refers.* In addition to these weaknesses, other conditions that we believe would not be in conformity with the criteria referred to above are described (reference to appropriate section of report).

This report is intended for the information of (applicant) and (agency) and should not be used for any other purpose.

.03 Since neither a pre-award nor post-award survey constitutes an audit of financial statements, the survey report should include a statement to that effect.

[Issue Date: January, 1973; modified: August, 1980.]

2. Award Survey Made in Conjunction With an Audit

.04 *Question*—How should the report differ when the study is made in conjunction with an audit engagement?

.05 *Interpretation*—The last sentence of the scope paragraph of the illustrative report in section 642.59 should be replaced by the following:

..... We have examined the financial statements of (recipient) for the year ended and have issued our report thereon dated

Also, the following sentence should be included in the paragraph that describes material weaknesses, if any:

These conditions were considered in determining the nature, timing, and extent of audit tests to be applied in our examination of the financial statements for the year ended and this report does not affect our report on these financial statements dated

[Issue Date: January, 1973; modified: August, 1980.]

3. Reporting on Matters Not Covered by Government-Established Criteria

.06 *Question*—The reports illustrated for pre-award and other surveys refer to the criteria set forth in an agency's audit guide. May the auditor provide negative assurance on other matters?

.07 *Interpretation*—Since it is not possible to anticipate all matters which may be of interest to the governmental agency, the auditor should not make a general statement in his report nothing else has come to his attention that would be of interest to the agency.

[Issue Date: January, 1973; modified: August, 1980.]

* If the auditor is aware of a material weakness in internal accounting control, whether or not he is specifically engaged by the client to review and report on the system of internal accounting control, a communication as described in section 323, *Required Communication of Material Weaknesses in Internal Accounting Control* (see Appendix G), is required.

4. Limited Scope

.08 Question—At times the terms of an engagement do not permit the examination of a delegate agency's (agencies') financial statements, internal accounting controls and compliance with provisions of an act and related regulations or instructions. How should the auditor modify his report on internal accounting control if he is not in a position to report on the delegate agency's (agencies') operations?

.09 Interpretation—If the operations of the delegate agency (agencies) are sufficiently material in the combined operations of the principal grant recipient and the delegate agency (agencies) and the latter is either unaudited or the work of other auditors is not acceptable to the primary auditor, an unqualified opinion cannot be expressed on the financial statements covering the combined operations of the principal grant recipient and the delegate agency (agencies). The report on internal accounting control, however, need not be an overall disclaimer if it clearly indicates in its scope and concluding paragraphs that it pertains only to the organization covered by the auditor's engagement. This distinction is appropriate if conditions with respect to internal accounting control in several organizations cannot be combined in a meaningful way and therefore there is no overall or combined system to which a disclaimer could relate.

[Issue Date: January, 1973; modified: August, 1980.]

5. Compliance With the Foreign Corrupt Practices Act of 1977

.10 Question—Certain provisions of the *Foreign Corrupt Practices Act of 1977*, generally referred to as the accounting provisions, amend the Securities Exchange Act of 1934 and provide in part that every issuer which has a class of securities registered under section 12 and every issuer which is required to file reports under section 15(d) shall devise and maintain a system of internal accounting control sufficient to provide reasonable assurance that—

- transactions are executed in accordance with management's general or specific authorization;
- transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (2) to maintain accountability for assets;
- access to assets is permitted only in accordance with management's general or specific authorization; and
- the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

.11 Section 621.18—19 provides guidance with respect to reports on compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements. May the auditor issue a report that provides assurance on an entity's compliance with this provision of the Act?

.12 Interpretation—No. The auditor should not issue a report that provides assurance on compliance with the internal accounting control provision of the Act. Section 621.18—19 was not intended to cover reports on

internal accounting control. Sections 323 (see Appendix G) and 642 apply to reports on internal accounting control. Although section 642 permits an auditor to express an opinion on an entity's system of internal accounting control, as explained in section 642.12: "Whether a company is in compliance with those provisions of the FCPA is a legal determination. An independent accountant's opinion does not indicate whether the company is in compliance with those provisions. . . ."

.13 Nevertheless, communications by the auditor as specified in sections 323 (see Appendix G) and 642 may be useful to an entity's management and its legal counsel in evaluating compliance with the internal accounting control provision of the Act. However, since the standards for determining a violation of the Act may differ from those applied by an auditor in determining material weaknesses, the auditor may wish to include a statement to that effect in any communication concerning internal accounting control.

[Issue Date: October, 1978; modified: August, 1980.]

6. Reports on Internal Accounting Control of Trust Departments of Banks

.14 *Question*—Independent accountants may be engaged to report on a system of internal accounting control maintained by the department of a bank or similar entity which is responsible for safeguarding assets held for others in trust or in custody accounts ("trust departments"). Trust departments may also execute investment transactions and be responsible for various administrative functions. While the trust department may have responsibility for the custody of trust assets, they are not assets of the bank and, therefore are not included in the bank's financial statements. Is it permissible for an accountant to express an opinion on the system of internal accounting control maintained by a trust department?

.15 *Interpretation*—Yes. Section 642.37 states: "An independent accountant may express an opinion on a system of internal accounting control of an entity for which financial statements in conformity with generally accepted accounting principles, or any other criteria applicable to such statements, *can be prepared*." (Emphasis added.) This does not mean that financial statements of the entity necessarily have to be prepared. When the "entity" is a segment, such as a subsidiary, a branch, or a department, the primary concern in applying the criterion of section 642.37 is that the assets and activities of the segment can be clearly distinguished, physically and operationally and for financial reporting purposes, from the other assets and activities of the organization. Accordingly, if the activities of the trust department are clearly distinguishable from other activities of the bank, and the scope of his work is not limited, an accountant can express an opinion on the system of internal accounting control maintained by the trust department.

.16 Ordinarily, the form of opinion on a system of internal accounting control is that the system taken as a whole was sufficient to meet the broad objectives of internal accounting control "insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the [entity's] financial statements." However, in engagements of this nature, the basis for assessing the materiality of potential errors or irregularities is the bank's financial statements since the responsibility for errors or irregularities occurring in the trust department would generally be borne by the bank.

.17 Also, the standard form of report should be revised to recognize the special objectives that exist when an accountant is expressing an opinion on a system of internal accounting control maintained by a trust department. The following type of report is considered appropriate in such circumstances. The description of the responsibilities of the trust department should be modified as appropriate based on the circumstances of the individual engagement.

We have made a study and evaluation of the system of internal accounting control of the Trust Department of Blank Bank and Trust Company in effect at [that existed during the year ended] (date), which department has responsibility for personal, custodial, and corporate trust accounts. Our study and evaluation was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

The management of Blank Bank and Trust Company is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets for which the Trust Department has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed and recorded in accordance with management's authorization and in conformity with the governing instruments.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system of future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

In our opinion, the system of internal accounting control of the Trust Department of Blank Bank and Trust Company in effect at [that existed during the year ended] (date), taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the financial statements of Blank Bank and Trust Company.

[Issue Date: January, 1981.]

[7.] Report Required by U.S. General Accounting Office^[1-7]

[.18—.25] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[8.] Form of Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit^[8-10]

[.26—.32] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

^[1-7] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

^[8-10] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[9.] Reporting on Internal Accounting Control Based Solely on an Audit When a Minimum Study and Evaluation Is Made

[.33—.34] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[10.] Report Required by U.S. General Accounting Office Based on a Financial and Compliance Audit When a Study and Evaluation Does Not Extend Beyond the Preliminary Review Phase ^[11-15]

[.35—.36] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[11.] Restricted Purpose Report Required by Law to Be Made Available to the Public ^[16]

[.37—.38] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

12. Reporting on Internal Accounting Control "Compliance With the Currency and Foreign Transactions Reporting Act"

.39 Question—Financial institutions are required by the Federal Home Loan Bank Board (FHLBB) to engage an independent auditor to study and test an institution's procedures for compliance with FHLBB T Memorandum 53-7 and issue a special purpose report in accordance with section 642, *Reporting on Internal Accounting Control*, paragraphs .60 and .61, in conjunction with the annual audit of the institution's financial statements. What are some procedures that the auditor might agree to perform to fulfill this requirement, and what is the proper form of the auditor's report?

.40 Interpretation—Examples of procedures that the auditor might agree to perform include, but are not limited to, the following. Note: An institution's location, types of customers, or other factors might require performing more detailed procedures.

I. Review operating procedures and compliance guidelines

A. Obtain and read relevant sections of the Currency and Foreign Transactions Reporting Act, 31 U.S.C. sections 5313 (Reports on exporting and importing monetary instruments), and 5318 (Compliance and exemptions), and related Treasury regulations, including any revisions or modifications; FHLBB Bulletin PA-7a-3; and FHLBB T Memorandums 53-7, 53-8, and 53-9. Understand requirements for:

1. Currency Transaction Report (Form 4789).
2. Reports of International Transportation of Currency or Monetary Instruments (Form 4790).
3. Maintenance of exemptions.

^[11-15] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

^[16] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

- B. Determine whether the institution has established, preferably in writing, operating procedures and compliance guidelines which cover:
 - 1. Filing of Form 4789.
 - 2. Filing of Form 4790.
 - 3. Maintenance of an exemption list.
 - C. Determine whether the institution's operation procedures and compliance guidelines include the following features discussed in T Memorandum 53-7:
 - 1. Requiring centralized control and review of compliance with the Currency and Foreign Transactions Reporting Act.
 - 2. Encouraging the reporting of large deposits consisting of numerous and/or out-of-area items of less than \$10,000.
 - 3. Encouraging the reporting of any unusual or suspicious purchase of cashier's checks, official checks, money orders, etc. by non-customers.
 - 4. Verifying the identity of non-customers purchasing such items from identity cards with pictures.
 - D. Determine whether the institution has established training programs for applicable employees regarding requirements of the Act and T Memorandum 53-7; completion of appropriate forms; verification of exemptions.
 - E. Determine whether the institution has established specific controls for identifying reportable transactions including controls established, if any, for accumulating and reporting transactions by or for any person which in any one day total more than \$10,000.*
- II. Compliance testing
- A. Select a sample of employees/periods that receive/disburse currency during the period.
 - 1. Determine whether employees have received training.
 - 2. Obtain cash proof sheets and other summary records including tapes or other detailed information for the test period.
 - 3. Identify reportable transactions. (The definition of "reportable transaction" can vary from institution to institution. That is, an institution could require any transaction over \$10,000 to be reported to the Treasury Department, as specified by the Currency and Foreign Transactions Reporting Act. Alternatively, an institution could establish a policy which requires any transaction of some specified amount

* The instructions for completing Form 4789 indicate that multiple transactions by or for any person which in any one day total more than \$10,000 should be treated as a single transaction, if the financial institution is aware of them.

of less than \$10,000 to be reported to a central reporting area for accumulation and review and subsequent reporting to the Treasury Department.)

- 4. For those identified, reportable transactions, ascertain whether they have been: (1) reported on the appropriate form or included on the exemption list, if not recorded; or (2) reported to a central reporting area for accumulation and review and subsequent reporting to the Treasury Department, if applicable.

- B. Obtain the file of reports submitted during the period.
 - 1. On a test basis, determine whether the forms are
 - completed properly;
 - submitted to the appropriate authority on a timely basis.
 - 2. Determine whether the institution has a procedure to retain copies of the reports filed for the past five years.
- C. Obtain the institution's list of exempt customers.
 - 1. On a test basis
 - Determine whether all required information has been obtained from exempt customers.
 - Determine that exemptions granted are approved and conform to the institution's policy.

.41 The following illustrates the type of auditor's report that would be issued under the FHLBB requirement:

SAMPLE REPORT

The Board of Directors
ABC Institution

At your request, we have performed the procedures described below with respect to the internal accounting control and administrative control procedures of ABC Institution for transactions subject to the reporting and recordkeeping provisions of the Currency and Foreign Transactions Reporting Act. Our procedures included tests of compliance with such internal accounting control and administrative control procedures during the period from through Our procedures were performed solely to assist you in determining compliance with FHLBB T Memorandum 53-7. This report is intended for the use of ABC Institution's management and the FHLBB and should not be used for any other purpose. The procedures we performed, and the results of these procedures, are summarized as follows:

(Description of procedures performed and findings)

Because the above procedures do not constitute a study and evaluation of the system of internal accounting control of ABC Institution in effect at, we do not express an opinion on whether the system, as a whole, meets the objectives of internal accounting control. Had we performed additional procedures, or had

we made a study and evaluation of the system of internal accounting control, other matters might have come to our attention that would have been reported to you. This report relates only to the procedures specified above and does not extend to any financial statements of ABC Institution.

[Issue Date: January, 1987.]

[The next page is 2025.]

AU Section 9711***Filings Under Federal Securities
Statutes: Auditing Interpretations
of AU Section 711*****1. Subsequent Events Procedures for Shelf Registration Statements Updated after the Original Effective Date**

.01 *Question*—Temporary Rule 415 of Regulation C under the Securities Act of 1933 (1933 Act) permits companies to register a designated amount of securities for continuous or delayed offerings by filing one “shelf” registration statement with the SEC. Under this rule, a registrant can register an amount of securities it reasonably expects to offer and sell within the next two years, generally without the later need to prepare and file a new prospectus and registration statement for each sale.

.02 A Rule 415 shelf registration statement can be updated after its original effective date by—

- a. The filing of a post-effective amendment,
- b. The incorporation by reference of subsequently filed material, or
- c. The addition of a supplemental prospectus (sometimes referred to as a “sticker”).

.03 Section 711, *Filings Under Federal Securities Statutes*, paragraph .05, states, “Because a registration statement under the Securities Act of 1933 speaks as of an effective date, the independent accountant whose report is included in such a registration statement has a statutory responsibility that is determined in the light of the circumstances on that date.” The independent accountant’s statutory responsibility regarding information covered by his report and included in a registration statement is specified in Section 11 of the 1933 Act. Section 11 states that the accountant will not be held liable if he can sustain a burden of proof that “he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a

material fact required to be stated therein or necessary to make the statements therein not misleading." To sustain the burden of proof that he has made a "reasonable investigation" as of the effective date, the accountant performs subsequent events procedures (as described in section 711.10 and .11) to a date as close to the effective date of the registration statement as is reasonable and practicable in the circumstances.

.04 In connection with Rule 415 shelf registrations, under what circumstances does the independent accountant have a responsibility to perform subsequent events procedures after the original effective date of the registration statement?

.05 *Interpretation*—As discussed in more detail below, in general, the accountant should perform the subsequent events procedures described in section 711.10 and .11, when either:

a. A post-effective amendment to the shelf registration statement, as defined by SEC rules, is filed pursuant to Item 512(a) of Regulation S-K,¹ or

b. A 1934 Act filing that includes or amends audited financial statements is incorporated by reference into the shelf registration statement.

.06 When a post-effective amendment is filed pursuant to the registrant's undertakings required by Item 512 of Regulation S-K, a shelf registration statement is considered to have a new effective date because Item 512(a)(2) of Regulation S-K states, "... for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement. . . ." Accordingly, in such cases, the accountant should perform subsequent events procedures to a date as close to the new effective date of the registration statement as is reasonable and practicable in the circumstances.

.07 Item 512(b) of Regulation S-K states that for purposes of determining any liability under the Securities Act of 1933 each filing of a registrant's annual report (Form 10-K) and each filing of an employee benefit plan annual report (Form 11-K) that is incorporated by reference into a shelf registration statement is deemed to be a new registration statement relating to the securities offering. Accordingly, when a Form 10-K or Form 11-K is incorporated by reference into a

¹ Item 512(a) of Regulation S-K provides that the registrant is required to undertake to file a post-effective amendment to a shelf registration statement to (a) file updated financial statements pursuant to section 10(a)(3) of the Securities Act of 1933, (b) reflect a "fundamental change" in the information in the registration statement arising from facts or events occurring after the effective date of the registration statement or previous post-effective amendments, or (c) include new material information regarding the plan of distribution.

shelf registration statement, the accountant should perform subsequent events procedures to a date as close to the date of the filing of the Form 10-K or Form 11-K as is reasonable and practicable in the circumstances and date his consent as of that date.

.08 In many circumstances, a Form 10-Q, Form 8-K, or other 1934 Act filing can be incorporated by reference into a shelf registration statement (sometimes this occurs automatically—for example, in a Form S-3 or Form S-8) without the need for a post-effective amendment. In those circumstances, the accountant has no responsibility to perform subsequent events procedures unless the filing includes or amends audited financial statements—for example, a Form 8-K that includes audited financial statements of an acquired company. In these latter circumstances, when the filing is incorporated into a registration statement, SEC rules require a currently dated consent of the accountant who examined those statements, and that accountant should perform subsequent events procedures to a date as close to the date of the incorporation by reference of the related material as is reasonable and practicable in the circumstances.²

.09 In addition, an accountant's report on a review of interim financial information contained in a Form 10-Q may also include his report on the information presented in the condensed year-end balance sheet that has also been included in the form and has been derived from the latest audited annual balance sheet. (See section 552.08, *Reporting on Condensed Financial Statements and Selected Financial Data*.) When the Form 10-Q is incorporated by reference into the shelf registration (which may occur automatically), the report on the year-end condensed balance sheet may be considered a report of an "expert." Because it is not clear what the accountant's responsibility is in those circumstances, the accountant should perform subsequent events procedures (as described in section 711.10 and .11) to a date as close to the date of the incorporation by reference of the Form 10-Q as is reasonable and practicable in the circumstances.

.10 One of the subsequent events procedures described in section 711 is to "read the entire prospectus and other pertinent portions of the registration statement." The reading of the entire prospectus (including any supplemental prospectuses and documents incorporated by reference—such as Form 10-Ks, 10-Qs, and 8-Ks) and the other procedures described in section 711.10 and .11, help assure that the accountant has fulfilled his statutory responsibilities under the 1933 Act to perform a "reasonable investigation."

²Typically in such cases, the affected audited financial statements are not those of the registrant, and accordingly, there would be no requirement for the registrant's auditor to update his subsequent events procedures with respect to the registrant's financial statements.

.11 When a shelf registration statement is updated by a supplemental prospectus (or "sticker"), the effective date of the registration statement is considered to be unchanged since the supplemental prospectus does not constitute an amendment to the registration statement, and, consequently, no post-effective amendment has been filed. Accordingly, an accountant has no responsibility to update his performance of subsequent events procedures through the date of the supplemental prospectus or sticker. The accountant, however, may nevertheless become aware that facts may have existed at the date of his report that might have affected his report had he then been aware of those facts. Section 711.12 and .13, provide guidance on the accountant's response to subsequent events and subsequently discovered facts.

[Issue Date: May, 1983.]

➡➡➡➡➡ *The next page is 2031.* ➡➡➡➡➡

AU Section 9722***Review of Interim Financial Information: Auditing Interpretations of AU Section 722*****1. Inquiry Concerning Litigation, Claims, and Assessments ***

.01 *Question*—Does a review of interim financial information, as specified by section 722 [“Review of Interim Financial Information”], require the reporting accountant to inquire of a client’s lawyer concerning litigation, claims, and assessments?

.02 *Interpretation*—A review of interim financial information does not contemplate obtaining corroborating evidential matter for responses to inquiries as a basis for issuing an unmodified accountant’s report (see section 722.03). Consequently, it is not necessary to send an audit inquiry letter to a client’s lawyer concerning litigation, claims, and assessments. However, if information comes to the accountant’s attention that leads him to question whether the unaudited interim information, insofar as litigation, claims, or assessments may be concerned, departs from generally accepted accounting principles and the accountant believes the client’s lawyer may have information concerning that question, an inquiry of the lawyer concerning the specific question is appropriate.

.03 When an accountant’s report on audited financial statements is included in a filing under the Securities Act of 1933, regardless of whether unaudited interim information is included, he should inquire of the client’s legal counsel concerning litigation, claims, and assessments (see sections 560.12 and 711.10). In those instances, it is appropriate to request an update of the lawyer’s previous audit inquiry response. A request to a lawyer to update an audit inquiry response previously obtained during an audit could ordinarily be limited to information concerning changes from the lawyer’s prior evaluation of matters covered by the audit inquiry response occasioned by interim developments plus any new matters arising since the last response.

[Issue Date: March, 1977; modified: May, 1981.]

* Transferred from section 9721, as modified by the issuance of Statement on Auditing Standards No. 36, *Review of Interim Financial Information*, April, 1981 (see section 722), and SAS No. 37, *Filings Under Securities Statutes*, April, 1981 (see section 711).

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APPENDIXES

... historical background ... statements on auditing procedure/standards/standards for attestation engagements/standards for accountants' services on prospective financial information ... sources of sections ... cross-references for auditing interpretations ... audit and accounting guides, and statements of position ... changes in statements on auditing standards ... AV sections superseded by SAS 53 through 61 ...

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AU Appendix A

Historical Background

The "Bulletins" of 1917, 1918, 1929, and 1936

In 1917, the American Institute of Certified Public Accountants, then known as the American Institute of Accountants, at the request of the Federal Trade Commission, prepared "a memorandum on balance-sheet audits," which the Commission approved and transmitted to the Federal Reserve Board.

The Federal Reserve Board, after giving the memorandum its provisional endorsement, published it in the *Federal Reserve Bulletin* of April 1917; reprints were widely disseminated for the consideration of "banks, bankers, banking associations; merchants, manufacturers, and associations of manufacturers; auditors, accountants, and associations of accountants" in pamphlet form with the title of "Uniform Accounting: a Tentative Proposal Submitted by the Federal Reserve Board."

In 1918, it was reissued under the same sponsorship, with a new title—"Approved Methods for the Preparation of Balance-Sheet Statements." There was practically no change from 1917 except that, as indicated by the respective titles and corresponding change in the preface, instead of the objective of "a uniform system of accounting to be adopted by manufacturing and merchandising concerns," the new objective was "the preparation of balance-sheet statements" for the same businesses.

In 1929, a special committee of the American Institute undertook revision of the earlier pamphlet in the light of the experience of the past decade; again under the auspices of the Federal Reserve Board, the revised pamphlet was issued in 1929 as "Verification of Financial Statements."

The preface of the 1929 pamphlet spoke of its predecessors as having been criticized, on the one hand, by some accountants for being "more comprehensive than their conception of the so-called balance-sheet audit," and, on the other hand, by other accountants because "the procedure would not bring out all the desired information." This recognition of opposing views evidenced the growing realization of the impracticability of uniform procedures to fit the variety of situations encountered in practice. Of significance is the appearance in the opening paragraph of "General Instructions" in the 1929 publication of the statement:

The extent of the verification will be determined by the conditions in each concern. In some cases, the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others, where the system of internal check is good, tests only may suffice. The responsibility for the extent of the work required must be assumed by the auditor.

Between 1932 and 1934, there was correspondence, dealing with both accounting and auditing matters, between the Institute's special committee on cooperation with stock exchanges and the committee on stock list of the New York Stock Exchange. The views expressed were an important development in the recognition of the position of accountancy in finance and business. The series of letters was published in 1934 under the title *Audits of Corporate Accounts*.

In 1936, a committee of the Institute prepared and published a further revision of the earlier pamphlets under the title of "Examination of Financial Statements by Independent Public Accountants." The Institute availed itself of the views of persons outside the ranks of the profession whose opinions would be helpful, but the authority behind and responsibility for the publication of the pamphlet rested wholly with the Institute as the authoritative representative of a profession that had by that time become well established in the business community.

In the 1936 revision, aside from the very briefly noted "Modifications of Program for Larger or Smaller Companies," the detailed procedures were restrictively stated to be an "outline of examination of financial statements of a small or moderate size company." Moreover, the nature and extent of such examinations were based on the purpose of the examination, the required detail to be reported on, the type of business, and, most important of all, the system of internal control; variations in the extent of the examination were specifically related to "the size of the organization and the personnel employed" and were said to be "essentially a matter of judgment which must be exercised by the accountant."

It is possible from the foregoing narrative to trace the development of the profession's view of an audit based on the experience of three decades. The succession of titles is illustrative. The earliest ambition for "uniform accounting" was quickly realized to be unattainable, and the same listed procedures were related instead to "balance-sheet statements." Then, with the gradually greater emphasis on periodic earnings, the earlier restrictive consideration of the balance sheet was superseded in the 1929 title, "Verification of Financial Statements," by according the income statement at least equal status. When in turn the 1936 revision was undertaken, there was a growing realization that, with the complexity of modern business and the need of the independent auditor to rely on testing, such a word as "verification" was not an accurate portrayal of the independent auditor's function.

Accordingly, the bulletin of that year was stated to cover an "examination" of financial statements.

Statements on Auditing Procedure

The Committee on Auditing Procedure had its beginning on January 30, 1939, when the executive committee of the Institute authorized the appointment of a small committee "to examine into auditing procedure and other related questions in the light of recent public discussion."

On May 9 of that year, the report "Extensions of Auditing Procedure" of this special committee was adopted by the Council of the Institute and authority given for its publication and distribution, and in the same year the bylaws were amended to create a standing Committee on Auditing Procedure.

In 1941, the executive committee authorized the issuance to Institute members, in pamphlet form, of the "Statements on Auditing Procedure," prepared by the Committee on Auditing Procedure, previously published only in *The Journal of Accountancy*.

The "Statements on Auditing Procedure" were designed to guide the independent auditor in the exercise of his judgment in the application of auditing procedures. In no sense were they intended to take the place of auditing textbooks; by their very nature textbooks must deal in a general way with the description of procedures and refinement of detail rather than the variety of circumstances encountered in practice that require the independent auditor to exercise his judgment.

Largely to meet this need, the Institute began the series of Statements on Auditing Procedure. The first of these presented the report of the original special committee, as modified and approved, at the Institute's annual meeting on September 19, 1939, and issued under the title of "Extensions of Auditing Procedure."

Statement No. 1 presented conclusions drawn from the experience and tradition of the profession which largely furnished the foundation for the Committee's present structural outline of auditing standards; the other Statements on Auditing Procedure appropriately fit into that structural outline.

The "Codification of Statements on Auditing Procedure" was issued by the Committee on Auditing Procedure in 1951 to consolidate the features of the first 24 pronouncements which were of continuing usefulness.

When the Securities and Exchange Commission adopted the requirement that a representation on compliance with generally accepted auditing standards be included in the independent auditor's report on financial statements filed with the Commission, it became apparent that a pronouncement was needed to define these standards. Accord-

ingly, the Committee undertook a special study of auditing standards (as distinguished from auditing procedures) and submitted a report that was published in October 1947 under the title "Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope." The recommendations of this brochure ceased to be tentative when, at the September 1948 meeting, the membership of the Institute approved the summarized statement of auditing standards.

In 1954 the "tentative" brochure was replaced by the booklet *Generally Accepted Auditing Standards—Their Significance and Scope*, which was issued as a special report of the Committee on Auditing Procedure. This pronouncement also gave recognition to the approval of Statement on Auditing Procedure No. 23 (Revised), "Clarification of Accountant's Report When Opinion Is Omitted" (1949) and the issuance of the "Codification" (1951).

Statement on Auditing Procedure No. 33 was issued in 1963 as a consolidation of, and a replacement for, the following pronouncements of the Committee on Auditing Procedure: Internal Control (1949), Generally Accepted Auditing Standards (1954), Codification of Statements on Auditing Procedure (1951), and Statements on Auditing Procedure Nos. 25-32, which were issued between 1951 and 1963. Statement No. 33 was a codification of earlier Committee pronouncements which the Committee believed to be of continuing interest to the independent auditor.

Statements on Auditing Standards

After issuance of Statement on Auditing Procedure No. 33, 21 additional Statements on Auditing Procedure, Nos. 34 to 54, were issued by the Committee on Auditing Procedure. In November 1972, these pronouncements were codified in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures. Also, in 1972, the name of the Committee was changed to the Auditing Standards Executive Committee to recognize its role as the AICPA's senior technical committee charged with interpreting generally accepted auditing standards.

The Auditing Standards Executive Committee issued 22 additional statements through No. 23. These statements were incorporated in the AICPA's looseleaf service, *Professional Standards*, as issued. The looseleaf service began in 1974 and is administered by the AICPA staff. It provides a continuous codification of Statements on Auditing Standards.

The Auditing Standards Board

As a result of the recommendations of the Commission on Auditors' Responsibilities, an independent study group appointed by the AICPA, a special committee was formed to study the structure of

the AICPA's auditing standard-setting activity. In May 1978, the AICPA Council adopted the recommendations of that committee to restructure the Committee. Accordingly, in October 1978 the Auditing Standards Board was formed as the successor to prior senior technical committees on auditing matters. The Board was given the following charge:

The AICPA Auditing Standards Board shall be responsible for the promulgation of auditing standards and procedures to be observed by members of the AICPA in accordance with the Institute's rules of conduct.

The board shall be alert to new opportunities for auditors to serve the public, both by the assumption of new responsibilities and by improved ways of meeting old ones, and shall as expeditiously as possible develop standards and procedures that will enable the auditor to assume those responsibilities.

Auditing standards and procedures promulgated by the board shall—

- a. Define the nature and extent of the auditor's responsibilities.
- b. Provide guidance to the auditor in carrying out his duties, enabling him to express an opinion on the reliability of the representations on which he is reporting.
- c. Make special provision, where appropriate, to meet the needs of small enterprises.
- d. Have regard to the costs which they impose on society in relation to the benefits reasonably expected to be derived from the audit function.

The auditing standards board shall provide auditors with all possible guidance in the implementation of its pronouncements, by means of interpretations of its statements, by the issuance of guidelines, and by any other means available to it.

➤ **Appendix B begins on page 2071.** ←

AU Appendix B

List of Statements on Auditing Procedure Nos. 1-54, Statements on Auditing Standards, Statements on Standards for Attestation Engagements, and Statement on Standards for Accountants' Services on Prospective Financial Information Issued to Date

Statements on Auditing Procedure

<u>No.</u>	<u>Date Issued</u>	<u>Title</u>
1	Oct. 1939	Extensions of Auditing Procedure
2	Dec. 1939	The Auditor's Opinion on the Basis of a Restricted Examination
3	Feb. 1940	Inventories and Receivables of Department Stores, Instalment Houses, Chain Stores, and Other Retailers
4	March 1941	Clients' Written Representations Regarding Inventories, Liabilities, and Other Matters
5	Feb. 1941	The Revised SEC Rule on "Accountants' Certificates"
6	March 1941	The Revised SEC Rule on "Accountants' Certificates" (continued)
7	March 1941	Contingent Liability Under Policies With Mutual Insurance Companies
8	Sept. 1941	Interim Financial Statements and the Auditor's Report Thereon
9	Dec. 1941	Accountants' Reports on Examinations of Securities and Similar Investments Under the Investment Company Act
10	June 1942	Auditing Under Wartime Conditions
11	Sept. 1942	The Auditor's Opinion on the Basis of a Restricted Examination (No. 2)
12	Oct. 1942	Amendment to Extensions of Auditing Procedure

Statements on Auditing Procedure—continued

<u>No.</u>	<u>Date Issued</u>	<u>Title</u>
13	Dec. 1942	The Auditor's Opinion on the Basis of a Restricted Examination (No. 3)—Face-Amount Certificate Companies
14	Dec. 1942	Confirmation of Public Utility Accounts Receivable
15	Dec. 1942	Disclosure of the Effect of Wartime Uncertainties on Financial Statements
16	Dec. 1942	Case Studies on Inventories
17	Dec. 1942	Physical Inventories in Wartime
18	Jan. 1943	Confirmation of Receivables From the Government
19	Nov. 1943	Confirmation of Receivables (Positive and Negative Methods)
20	Dec. 1943	Termination of Fixed Price Supply Contracts
21	July 1944	Wartime Government Regulations
22	May 1945	References to the Independent Accountant in Securities Registrations
23	Dec. 1949	Clarification of Accountant's Report When Opinion is Omitted (Revised)
24	Oct. 1948	Revision in Short-Form Accountant's Report or Certificate
25	Oct. 1954	Events Subsequent to the Date of Financial Statements
26	April 1956	Reporting on Use of "Other Procedures"
27	July 1957	Long-Form Reports
28	Oct. 1957	Special Reports
29	Oct. 1958	Scope of the Independent Auditor's Review of Internal Control
30	Sept. 1960	Responsibilities and Functions of the Independent Auditor in the Examination of Financial Statements
31	Oct. 1961	Consistency
32	Sept. 1962	Qualifications and Disclaimers
33	Dec. 1963	Auditing Standards and Procedures (a codification)
34	Sept. 1965	Long-Term Investments
35	Nov. 1965	Letters for Underwriters
36	Aug. 1966	Revision of "Extensions of Auditing Procedure" Relating to Inventories

Statements on Auditing Procedure—continued

<u>No.</u>	<u>Date Issued</u>	<u>Title</u>
37	Sept. 1966	Special Report: Public Warehouses—Controls and Auditing Procedures for Goods Held
38	Sept. 1967	Unaudited Financial Statements
39	Sept. 1967	Working Papers
40	Oct. 1968	Reports Following a Pooling of Interests
41	Oct. 1969	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report
42	Jan. 1970	Reporting When a Certified Public Accountant Is Not Independent
43	Sept. 1970	Confirmation of Receivables and Observation of Inventories
44	April 1971	Reports Following a Pooling of Interests
45	July 1971	Using the Work and Reports of Other Auditors
46	July 1971	Piecemeal Opinions
47	Sept. 1971	Subsequent Events
48	Oct. 1971	Letters for Underwriters
49	Nov. 1971	Reports on Internal Control
50	Nov. 1971	Reporting on the Statement of Changes in Financial Position
51	July 1972	Long-Term Investments
52	Oct. 1972	Reports on Internal Control Based on Criteria Established by Governmental Agencies
53	Nov. 1972	Reporting on Consistency and Accounting Changes
54	Nov. 1972	The Auditor's Study and Evaluation of Internal Control

Statements on Auditing Standards

<u>No.</u>	<u>Date Issued</u>	<u>Title</u>	<u>Section</u>
1	Nov. 1972	Codification of Auditing Standards and Procedures See Appendix C	
2	Oct. 1974	Reports on Audited Financial Statements	509 *
3	Dec. 1974	(Superseded by SAS 48.)	
4	Dec. 1974	(Superseded by SAS 25.)	

* See Appendix G.

Statements on Auditing Standards—continued

<u>No.</u>	<u>Date Issued</u>	<u>Title</u>	<u>Section</u>
5	July 1975	The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report	411
6	July 1975	(Superseded by SAS 45.)	
7	Oct. 1975	Communications Between Predecessor and Successor Auditors	315
8	Dec. 1975	Other Information in Documents Containing Audited Financial Statements	550
9	Dec. 1975	The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination	322
10	Dec. 1975	(Superseded by SAS 24.)	
11	Dec. 1975	Using the Work of a Specialist	336
12	Jan. 1976	Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments	337
13	May 1976	(Superseded by SAS 24.)	
14	Dec. 1976	Special Reports	621
15	Dec. 1976	Reports on Comparative Financial Statements	505 *
16	Jan. 1977	The Independent Auditor's Responsibility for the Detection of Errors or Irregularities	327 *
17	Jan. 1977	Illegal Acts by Clients	328 *
18	May 1977	(Withdrawn by Auditing Standards Board.)	
19	June 1977	Client Representations	333
20	Aug. 1977	Required Communication of Material Weaknesses in Internal Accounting Control	323 *
21	Dec. 1977	Segment Information	435
22	Mar. 1978	Planning and Supervision	311
23	Oct. 1978	Analytical Review Procedures	318 *
24	Mar. 1979	(Superseded by SAS 36.)	
25	Nov. 1979	The Relationship of Generally Accepted Auditing Standards to Quality Control Standards	161
26	Nov. 1979	Association With Financial Statements	504
27	Dec. 1979	(Superseded by SAS 52.)	
28	June 1980	(Withdrawn by SAS 52.)	

* See Appendix G.

Statements on Auditing Standards—continued

<u>No.</u>	<u>Date Issued</u>	<u>Title</u>	<u>Section</u>
29	July 1980	Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents	551
30	July 1980	Reporting on Internal Accounting Control	642 [†]
31	Aug. 1980	Evidential Matter	326
32	Oct. 1980	Adequacy of Disclosure of Financial Statements	431
33	Oct. 1980	(Superseded by SAS 45.)	
34	Mar. 1981	The Auditor's Considerations When a Question Arises About an Entity's Continued Existence	340 ^{††}
35	April 1981	Special Reports—Applying Agreed-upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement	622
36	April 1981	Review of Interim Financial Information	722
37	April 1981	Filings Under Federal Securities Statutes	711
38	April 1981	(Superseded by SAS 49.)	
39	June 1981	Audit Sampling	350
40	Feb. 1982	(Superseded by SAS 52.)	556
41	April 1982	Working Papers	339
42	Sept. 1982	Reporting on Condensed Financial Statements and Selected Financial Data	552
43	Aug. 1982	Omnibus Statement on Auditing Standards*	
44	Dec. 1982	Special-Purpose Reports on Internal Accounting Control at Service Organizations	324
45	Aug. 1983	Omnibus Statement on Auditing Standards—1983**	
46	Sept. 1983	Consideration of Omitted Procedures After the Report Date	390
47	Dec. 1983	Audit Risk and Materiality in Conducting an Audit	312

[†] See Appendix G for paragraphs .47—.53, "Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit."

^{††} See Appendix G.

* Statement on Auditing Standards No. 43 has been integrated within sections 150.06, 320.50—.56 (see Appendix G), 320.59—.62 (see Appendix G), 331.14, 350.46, 420.15, 509.39 (see Appendix G), 901.01, 901.24 and 901.28.

** Statement on Auditing Standards No. 45 has created new sections 313, *Substantive Tests Prior to the Balance Sheet Date*; 334, *Related Parties*; and 557, *Supplementary Oil and Gas Reserve Information* (withdrawn by the issuance of SAS No. 52).

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*** Statement on Auditing Standards No. 48 has been integrated within sections 311.03, 311.09—.10, 318.07 (see Appendix G), 320.33—.34 (see Appendix G), 320.37 (see Appendix G), 320.57—.58 (see Appendix G), 320.65—.68 (see Appendix G) and 326.12.

† Statement on Auditing Standards No. 52 has been integrated within sections 411.05—.08 and 551.15 and has created a new section 558, *Required Supplementary Information*.

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621.08	Planning Considerations for an Audit of a Federally Assisted Program (No. 2)	9311.04-.34
621.08	Reports on the Financial Statements Included in Internal Revenue Form 990, "Return of Organizations Exempt From Income Tax" (No. 10)	9621.47-.54
621.09	Planning Considerations for an Audit of a Federally Assisted Program (No. 2)	9311.04-.34
621.09	Reports on Elements, Accounts, or Items of a Financial Statement That Are Presented in Conformity with GAAP (No. 2)	9621.09-.10
621.10	Planning Considerations for an Audit of a Federally Assisted Program (No. 2)	9311.04-.34
621.10	Reports on Elements, Accounts, or Items of a Financial Statement That Are Presented in Conformity With GAAP (No. 2)	9621.09-.10
621.10	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9)	9621.40-.46
621.11	Planning Considerations for an Audit of a Federally Assisted Program (No. 2)	9311.04-.34
621.11	Reports on Elements, Accounts, or Items of a Financial Statement That Are Presented in Conformity With GAAP (No. 2)	9621.09-.10
621.11	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9)	9621.40-.46
621.12	Planning Considerations for an Audit of a Federally Assisted Program (No. 2)	9311.04-.34
621.12	Reports on Elements, Accounts, or Items of a Financial Statement That Are Presented in Conformity With GAAP (No. 2)	9621.09-.10

<i>Section</i>	<i>Interpretation Subject (Interpretation No.)</i>	<i>Interpretation Section</i>
621.12	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9)	9621.40-.46
621.13	Planning Considerations for an Audit of a Federally Assisted Program (No. 2)	9311.04-.34
621.13	Reports on Elements, Accounts, or Items of a Financial Statement That Are Presented in Conformity With GAAP (No. 2)	9621.09-.10
621.13	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9)	9621.40-.46
621.14	Planning Considerations for an Audit of a Federally Assisted Program (No. 2)	9311.04-.34
621.14	Reports on Elements, Accounts, or Items of a Financial Statement That Are Presented in Conformity With GAAP (No. 2)	9621.09-.10
621.14	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9)	9621.40-.46
621.18	Compliance With the Foreign Corrupt Practices Act of 1977 (No. 5)	9642.10-.13
621.19	Compliance With the Foreign Corrupt Practices Act of 1977 (No. 5)	9642.10-.13
621.20	Planning Considerations for an Audit of a Federally Assisted Program (No. 2)	9311.04-.34
621.21	Planning Considerations for an Audit of a Federally Assisted Program (No. 2)	9311.04-.34
622	Reporting on Solvency (No. 6)	9504.23-.35
634.02	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1)	9634.01-.09
634.24	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2)	9634.10-.12
634.25	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2)	9634.10-.12
634.26	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2)	9634.10-.12
634.27	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2)	9634.10-.12
634.28	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2)	9634.10-.12

<i>Section</i>	<i>Interpretation Subject (Interpretation No.)</i>	<i>Interpretation Section</i>
634.29	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2)	9634.10-.12
634.30	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2)	9634.10-.12
634.31	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2)	9634.10-.12
634.40	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1)	9634.01-.09
634.41	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1)	9634.01-.09
634.42	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1)	9634.01-.09
634.43	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1)	9634.01-.09
634.44	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1)	9634.01-.09
634.45	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1)	9634.01-.09
642.10	Report Required by U. S. General Accounting Office Based on a Financial and Compliance Audit When a Study and Evaluation Does Not Extend Beyond the Preliminary Review Phase (No. 10)	9642.35-.36*
642.12	Compliance With the Foreign Corrupt Practices Act of 1977 (No. 5)	9642.10-.13
642.20	Report Required by U. S. General Accounting Office (No. 7)	9642.18-.25*
642.37	Reports on Internal Accounting Control of Trust Departments of Banks (No. 6)	9642.14-.17
642.48	Reports by Management on Internal Accounting Control (No. 1)	9550.01-.06
642.48	Report Required by U. S. General Accounting Office (No. 7)	9642.18-.25*
642.48	Form of Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit (No. 8)	9642.26-.32*
642.48	Reporting on Internal Accounting Control Based Solely on an Audit When a Minimum Study and Evaluation Is Made (No. 9)	9642.33-.34*

[The next page is 2099-5.]

* See Appendix G.

<i>Section</i>	<i>Interpretation Subject (Interpretation No.)</i>	<i>Interpretation Section</i>
642.48	Report Required by U. S. General Accounting Office Based on a Financial and Compliance Audit When a Study and Evaluation Does Not Extend Beyond the Preliminary Review Phase (No. 10)	9642.35-.36*
642.48	Restricted Purpose Report Required by Law to Be Made Available to the Public (No. 11)	9642.37-.38*
642.49	Report Required by U. S. General Accounting Office (No. 7)	9642.18-.25*
642.49	Form of Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit (No. 8)	9642.26-.32*
642.49	Reporting on Internal Accounting Control Based Solely on an Audit When a Minimum Study and Evaluation Is Made (No. 9)	9642.33-.34*
642.49	Restricted Purpose Report Required by Law to Be Made Available to the Public (No. 11)	9642.37-.38*
642.50	Form of Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit (No. 8)	9642.26-.32*
642.50	Reporting on Internal Accounting Control Based Solely on an Audit When a Minimum Study and Evaluation Is Made (No. 9)	9642.33-.34*
642.53	Form of Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit (No. 8)	9642.26-.32*
642.59	Pre-Award Surveys (No. 1)	9642.01-.03
642.59	Award Survey Made in Conjunction With an Audit (No. 2)	9642.04-.05
642.60	Reporting on Internal Accounting Control "Compliance With the Currency and Foreign Transactions Reporting Act" (No. 12)	9642.39-.41
642.61	Reporting on Internal Accounting Control "Compliance With the Currency and Foreign Transactions Reporting Act" (No. 12)	9642.39-.41
711.05	Subsequent Events Procedures for Shelf Registration Statements Updated After the Original Effective Date (No. 1)	9711.01-.11
711.10	Subsequent Events Procedures for Shelf Registration Statements Updated After the Original Effective Date (No. 1)	9711.01-.11
711.10	Inquiry Concerning Litigation, Claims, and Assessments (No. 1)	9722.01-.03

* See Appendix G.

<i>Section</i>	<i>Interpretation Subject (Interpretation No.)</i>	<i>Interpretation Section</i>
711.11	Subsequent Events Procedures for Shelf Registration Statements Updated After the Original Effective Date (No. 1)	9711.01-.11
711.12	Subsequent Events Procedures for Shelf Registration Statements Updated After the Original Effective Date (No. 1)	9711.01-.11
711.13	Subsequent Events Procedures for Shelf Registration Statements Updated After the Original Effective Date (No. 1)	9711.01-.11
722.03	Inquiry Concerning Litigation, Claims, and Assessments Updated After the Original Effective Date (No. 1)	9722.01-.03

AU Appendix E

AICPA Audit and Accounting Guides and Statements of Position

Audit and Accounting Guides

Audit Sampling, Statistical Sampling Subcommittee, 1983.

The Auditor's Study and Evaluation of Internal Control in EDP Systems, Computer Services Executive Committee, 1977.

Audits of Agricultural Producers and Agricultural Cooperatives, Agribusiness Special Committee, 1987; *Statement of Position*, Accounting by Agricultural Producers and Agricultural Cooperatives, Accounting Standards Division, April 1985.

Audits of Airlines, Civil Aeronautics Subcommittee, 1981.

Audits of Banks, Banking Committee, Second Edition, 1984; *Statement of Position*, Reporting by Banks of Investment Securities Gains or Losses, Accounting Standards Division, December 1983.

Audits of Brokers and Dealers in Securities, Subcommittee on Stockbrokerage Auditing, Revised Edition, 1985.

Audits of Casinos, Gaming Industry Special Committee, 1984.

Audits of Certain Nonprofit Organizations, Subcommittee on Nonprofit Organizations, Second Edition 1988; *Statement of Position*, Accounting Principles and Reporting Practices for Certain Nonprofit Organizations, Accounting Standards Division, December 1978; *Statement of Position*, Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal, August 1987.

Audits of Colleges and Universities, Committee on College and University Accounting and Auditing, Second Edition, 1975; *Statement of Position*, Financial Accounting and Reporting by Colleges and Universities, Accounting Standards Division, August 1974.

Audits of Credit Unions, Credit Unions Committee, 1986.

Audits of Employee Benefit Plans, Employee Benefit Plans and ERISA Special Committee, 1983.

Audits of Entities With Oil and Gas Producing Activities, Oil and Gas Committee, 1986.

Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies), Finance Companies Guide Special Committee, Second Edition, 1988.

*Audits of Fire and Casualty Insurance Companies**, Committee on Insurance Accounting and Auditing, Fourth Edition, 1982; *Statement of Position*, Revision of Form of Auditor's Report, Auditing Standards Division,

* Financial accounting and reporting principles and practices described in the indicated Audit and Accounting Guides and Statements of Position have been extracted by the FASB

Audit and Accounting Guides—Continued

- July 1974; *Statement of Position*, Auditing Property and Liability Reinsurance, Auditing Standards Division, October 1982.
- Audits of Government Contractors*, Task Force on Defense Contract Agencies, Second Edition, 1983; *Statement of Position*, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, Accounting Standards Division, July 1981.
- Audits of Investment Companies*, Investment Companies Special Committee, 1987.
- Audits of Service-Center-Produced Records*, Service-Center-Produced Records Task Force, Revised Edition, 1987.
- Audits of State and Local Governmental Units*, State and Local Government Committee, Revised Edition, 1986.
- Audits of Stock Life Insurance Companies**, Committee on Insurance Accounting and Auditing, Fourth Edition, 1985; *Statement of Position*, Confirmation of Insurance Policies in Force, Auditing Standards Division, August 1978; *Statement of Position*, Auditing Life Reinsurance, Auditing Standards Division, November 1984.
- Audits of Voluntary Health and Welfare Organizations*, Committee on Voluntary Health and Welfare Organizations, 1974; *Statement of Position*, Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal, Accounting Standards Division, August 1987.
- Computer-Assisted Audit Techniques*, Computer Services Executive Committee, 1979.
- Construction Contractors*, Construction Contractor Guide Committee, 1981; *Statement of Position*, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, Accounting Standards Division, July 1981.
- Guide for Prospective Financial Statements*, Financial Forecasts and Projections Task Force, 1986.
- Guide for the Use of Real Estate Appraisal Information*, Real Estate Committee, 1987.
- Hospital Audit Guide*, Committee on Health Care Institutions, Fifth Edition, 1985; *Statement of Position*, Clarification of Accounting, Auditing, and Reporting Practices Relating to Hospital Malpractice Loss Contingencies, Auditing Standards Division, March 1978; *Statement of Position*, Accounting by Hospitals for Certain Marketable Equity Securities, Accounting Standards Division, May 1978; *Statement of Position*, Financial Accounting and Reporting by Hospitals Operated by a Governmental Unit, Accounting Standards Division, July 1978; *Statement of Position*, Reporting Practices Concerning Hospital-Related Organizations, Accounting Standards Division, August 1981; *Statement of*

(Footnote Continued)

and issued as Statements of Financial Accounting Standards, which are enforceable under Rule 203 of the AICPA Rules of Conduct.

* Financial accounting and reporting principles and practices described in the indicated Audit and Accounting Guides and Statements of Position have been extracted by the FASB and issued as Statements of Financial Accounting Standards, which are enforceable under Rule 203 of the AICPA Rules of Conduct.

Audit and Accounting Guides—Continued

Position, Financial Reporting by Not-for-Profit Health Care Entities for Tax-Exempt Debt and Certain Funds Whose Use Is Limited, Accounting Standards Division, January 1985.

Personal Financial Statements Guide, Personal Financial Statements Task Force, 1983; *Statement of Position, Accounting and Financial Reporting for Personal Financial Statements*, Accounting Standards Division, October 1982.

Savings and Loan Associations, Committee on Savings and Loan Associations, Second Revised Edition, 1985; *Statement of Position, Accounting for Dollar Repurchase—Dollar Reverse Repurchase Agreements by Sellers-Borrowers*, Accounting Standards Division, January 1985; *Statement of Position, Reporting Repurchase—Reverse Repurchase Agreement and Mortgage-Backed Certificates by Savings and Loan Associations*, September 1986.

Statements of Position of the Auditing Standards Division

<i>Revision of Form of Auditor's Report, Audits of Fire and Casualty Insurance Companies</i>	7/74
<i>Clarification of Accounting, Auditing, and Reporting Practices Relating to Hospital Malpractice Loss Contingencies, Hospital Audit Guide</i>	3/78
<i>Confirmation of Insurance Policies in Force, Audits of Stock Life Insurance Companies</i>	8/78
<i>Auditing Property and Liability Reinsurance</i>	10/82
<i>Auditing Life Reinsurance</i>	11/84

Statements of Position of the Accounting Standards Division

<i>Financial Accounting and Reporting by Colleges and Universities</i>	8/74
<i>Financial Accounting and Reporting by Face-Amount Certificate Companies</i>	12/74
<i>Accounting Practices of Real Estate Investment Trusts</i>	6/75
<i>Accounting Practices for Certain Employee Stock Ownership Plans</i> ...	12/76
<i>Financial Accounting and Reporting by Investment Companies</i>	4/77
<i>Accounting by Hospitals for Certain Marketable Equity Securities</i> ...	5/78
<i>Accounting Practices of Real Estate Investment Trusts</i>	5/78
<i>Accounting for Investments in Real Estate Ventures</i>	12/78
<i>Accounting Principles and Reporting Practices for Certain Nonprofit Organizations</i>	12/78
<i>Accounting for Municipal Bond Funds</i>	1/79
<i>Accounting for Performance of Construction-Type and Certain Production-Type Contracts</i>	7/81
<i>Reporting Practices Concerning Hospital-Related Organizations</i>	8/81
<i>Accounting and Reporting for Personal Financial Statements</i>	10/82
<i>Reporting by Banks of Investment Securities Gains or Losses</i>	12/83

**Statements of Position of the Accounting Standards Division—
Continued**

<i>Financial Reporting by Not-for-Profit Health Care Entities for Tax-Exempt Debt and Certain Funds Whose Use Is Limited</i>	1/85
<i>Accounting for Dollar Repurchase—Dollar Reverse Repurchase Agreements by Sellers-Borrowers</i>	1/85
<i>Accounting by Agricultural Producers and Agricultural Cooperatives</i>	4/85
<i>Reporting Repurchase—Reverse Repurchase Agreements and Mortgage-Backed Certificates by Savings and Loan Associations</i>	9/86
<i>Accounting for Asserted and Unasserted Medical Malpractice Claims of Health Care Providers and Related Issues</i>	3/87
<i>Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal</i>	8/87

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AU Appendix F

Schedule of Changes in Statements on Auditing Standards

<i>Section</i>	<i>Par.</i>	<i>Changes</i>	<i>Date of Change</i>
110	.05-.08	Superseded by SAS 16	January, 1977
150	.06	Amended by SAS 43	August, 1982
160		Superseded by SAS 25	November, 1979
210	.05	Amended by SAS 5	July, 1975
230	.04	Amended by SAS 41	April, 1982
310	.02	Amended by SAS 45	August, 1983
310	.03	Amended by SAS 45	August, 1983
310	.05-.09	Superseded by SAS 45	August, 1983
311	.03	Amended by SAS 47	December, 1983
311	.03	Amended by SAS 48	July, 1984
311*	.09	New paragraph added by issuance of SAS 48	July, 1984
311	.10	New paragraph added by issuance of SAS 48	July, 1984
315	.11	Superseded by SAS 15	December, 1976
318	.07	Amended by SAS 48	July, 1984
318		Superseded by SAS 56	April, 1988
320**	.03	Superseded by SAS 48	July, 1984
320	.32	Amended by SAS 3	December, 1974
320	.33	New paragraph added by issuance of SAS 48	July, 1984
320	.34	New paragraph added by issuance of SAS 48	July, 1984
320	.37	Amended by SAS 48	July, 1984
320	.50	Amended by SAS 43	August, 1982
320	.51	Amended by SAS 43	August, 1982
320	.52	Amended by SAS 43	August, 1982
320	.53	Amended by SAS 43	August, 1982
320	.54	Amended by SAS 43	August, 1982
320	.55	Amended by SAS 43	August, 1982
320	.56	Amended by SAS 43	August, 1982
320	.57	New paragraph added by issuance of SAS 48	July, 1984
320	.58	New paragraph added by issuance of SAS 48	July, 1984

* Section 311 paragraphs .09 through .13 renumbered .11 through .15 by issuance of Statement on Auditing Standards No. 48.

** Section 320 paragraphs .56 through .75 renumbered .60 through .79 by issuance of Statement on Auditing Standards No. 43. Section 320 paragraphs .04 through .79 renumbered .03 through .84 by issuance of Statement on Auditing Standards No. 48.

<u>Section</u>	<u>Par.</u>	<u>Changes</u>	<u>Date of Change</u>
320	.59	New paragraph added by issuance of SAS 43	August, 1982
320	.60	New paragraph added by issuance of SAS 43	August, 1982
320	.61	New paragraph added by issuance of SAS 43	August, 1982
320	.62	New paragraph added by issuance of SAS 43	August, 1982
320	.65	Amended by SAS 48	July, 1984
320	.66	New paragraph added by issuance of SAS 48	July, 1984
320	.67	Amended by SAS	July, 1984
320	.68	New paragraph added by issuance of SAS 48	July, 1984
320	.73	Amended by SAS 20	August, 1977
320	.73	Amended by SAS 30	July, 1980
320	.75	Amended by SAS 23	October, 1978
320	.77	Amended by SAS 39	June, 1981
320	.79	Superseded by SAS 9	December, 1975
320		Superseded by SAS 55	April, 1988
320A		Superseded by SAS 39	June, 1981
320B		Superseded by SAS 39	June, 1981
321		Superseded by SAS 48	July, 1984
323	.01	Amended by SAS 24	March, 1979
323	.01	Amended by SAS 30	July, 1980
323	.08	Amended by SAS 30	July, 1980
323	.09	Amended by SAS 30	July, 1980
323		Superseded by SAS 60	April, 1988
326*	.12	New paragraph added by issuance of SAS 48	August, 1984
327	.08	Amended by SAS 30	July, 1980
327		Superseded by SAS 53	April, 1988
328		Superseded by SAS 54	April, 1988
330		Superseded by SAS 31	August, 1980
331	.14	Amended by SAS 43	August, 1982
331**	.15	Deleted by SAS 43	August, 1982
331**	.15	Amended by SAS 2	December, 1974
332	.16	Amended by SAS 2	December, 1974
335	.01-.19	Superseded by SAS 45	August, 1983
338		Superseded by SAS 41	April, 1982
340		Superseded by SAS 59	April, 1988

* Section 326 paragraphs .12 through .23 renumbered .13 through .24 by issuance of Statement on Auditing Standards No. 48.

** Section 331 paragraph .16 (as amended by SAS 2) renumbered .15 by issuance of Statement on Auditing Standards No. 43.

<u>Section</u>	<u>Par.</u>	<u>Changes</u>	<u>Date of Change</u>
350	.08-.09	Amended by SAS 45	August, 1983
350	.11	Amended by SAS 45	August, 1983
350	.46	Amended by SAS 43	June, 1982
350	.47	Amended by SAS 45	August, 1983
410	.02	Amended by SAS 14	December, 1976
410	.03-.04	Superseded by SAS 5	July, 1975
411	.05-.06	Amended by SAS 43	August, 1982
411	.05-.08	Amended by SAS 52	April, 1988
411*	.07-.08	New paragraph added by issuance of SAS 43	August, 1982
420**	.15	Amended by SAS 43	August, 1982
420	.16	Deleted by SAS 43	August, 1982
430	.04	Amended by SAS 21	December, 1977
430		Superseded by SAS 32	October, 1980
504	.20	Amended by SAS 35	April, 1981
505	.05	Amended by SAS 43	August, 1982
505	.06	Amended by SAS 34	March, 1981
505	.13-.15	Superseded by SAS 26	November, 1979
505		Superseded by SAS 58	April, 1988
509	.17	Amended by SAS 21	December, 1977
509	.18	Amended by SAS 5	July, 1975
509	.39	Amended by SAS 43	August, 1982
509	.45	Amended by SAS 26	November, 1979
509	.49	Superseded by SAS 15	December, 1976
509		Superseded by SAS 58	April, 1988
510		Superseded by SAS 2	December, 1974
511		Superseded by SAS 2	December, 1974
512		Superseded by SAS 2	December, 1974
513		Superseded by SAS 2	December, 1974
514		Superseded by SAS 2	December, 1974
515		Superseded by SAS 2	December, 1974
516	.02	Amended by SAS 2	December, 1974
516	.09	Amended by SAS 13	May, 1976
516	.09	Amended by SAS 24	March, 1979
516	.11	Amended by SAS 2	December, 1974
516	.11-.12	Superseded by SAS 15	December, 1976
516	.14	Amended by SAS 21	December, 1977
516		Superseded by SAS 26	November, 1979
517		Superseded by SAS 26	November, 1979

* Section 411 paragraphs .07 through .09 renumbered .09 through .11 by issuance of Statement on Auditing Standards No. 43.

** Section 420 paragraphs .17 through .21 renumbered .16 through .20 by issuance of Statement on Auditing Standards No. 43.

<u>Section</u>	<u>Par.</u>	<u>Changes</u>	<u>Date of Change</u>
518	.03	Amended by SAS 14	December, 1976
518		Superseded by SAS 26	November, 1979
519		Superseded by SAS 24	March, 1979
535		Superseded by SAS 2	December, 1974
540		Superseded by SAS 2	December, 1974
541		Superseded by SAS 2	December, 1974
542	.01-.04	Superseded by SAS 2	December, 1974
542		Superseded by SAS 58	April, 1988
543	.18	Superseded by SAS 7	November, 1975
544	.01	Superseded by SAS 2	December, 1974
544	.02	Amended by SAS 2	December, 1974
544	.02	Amended by SAS 14	December, 1976
544	.04	Amended by SAS 14	December, 1976
545	.01	Amended by SAS 21	December, 1977
545	.05	Amended by SAS 21	December, 1977
545		Superseded by SAS 58	April, 1988
546	.17	Amended by SAS 2	December, 1974
546		Superseded by SAS 58	April, 1988
547		Superseded by SAS 2	December, 1974
551	.15	Amended by SAS 52	April, 1988
553	.02	Amended by SAS 33	October, 1980
553	.08	Amended by SAS 29	December, 1980
553	.11	Amended by SAS 29	December, 1980
553		Superseded by SAS 52	April, 1988
554		Superseded by SAS 52	April, 1988
555	.01-.06	Superseded by SAS 45	August, 1983
556		Superseded by SAS 52	April, 1988
557		Superseded by SAS 52	April, 1988
560	.12d	Amended by SAS 12	January, 1976
610		Superseded by SAS 29	December, 1980
620		Superseded by SAS 14	December, 1976
621	.05	Amended by SAS 35	April, 1981
621	.15-.17	Superseded by SAS 35	April, 1981
630		Superseded by SAS 38	April, 1981
631	.47	Amended by SAS 43	August, 1982
631	.51	Amended by SAS 43	August, 1982
631	.56	Amended by SAS 43	August, 1982
631		Superseded by SAS 49	September, 1984
640	.01	Amended by SAS 20	August, 1977
640	.12-.13	Amended by SAS 20	August, 1977
640		Superseded by SAS 30	July, 1980
641		Superseded by SAS 30	July, 1980

<u>Section</u>	<u>Par.</u>	<u>Changes</u>	<u>Date of Change</u>
642	.02	Amended by SAS 44	December, 1982
642	.47-.53	Superseded by SAS 60	April, 1988
642	.60	Amended by SAS 44	December, 1982
710	.11	Amended by SAS 15	December, 1976
710		Superseded by SAS 37	April, 1981
720	.22	Amended by SAS 13	May, 1976
720		Superseded by SAS 24	March, 1979
721	.02	Amended by SAS 26	November, 1979
721		Superseded by SAS 36	April, 1981
730		Withdrawn by Auditing Standards Board	April, 1981
901	.01	Amended by SAS 43	August, 1982
901*	.02	Deleted by SAS 43	August, 1982
901	.03	Deleted by SAS 43	August, 1982
901	.04	Deleted by SAS 43	August, 1982
901	.05	Deleted by SAS 43	August, 1982
901	.24	Amended by SAS 43	August, 1982
901	.28	Amended by SAS 43	August, 1982

[The next page is 2131.]

* Section 901 paragraphs .06 through .32 renumbered .02 through .28 by issuance of Statement on Auditing Standards No. 43.

AU Appendix G

AU Sections Superseded by Statements on Auditing Standards Numbers 53 through 61

INTRODUCTION

Currently, AICPA **Professional Standards**, volume 1, includes the appropriate AU sections for Statements on Auditing Standards (SAS) Numbers 53 through 61 issued in April 1988 with effective dates as shown:

- Effective for audits of financial statements for periods beginning after January 1, 1989
 - SAS No. 53 *The Auditor's Responsibility to Detect and Report Errors and Irregularities* [See section 316]
 - SAS No. 54 *Illegal Acts By Clients* [See section 317]
 - SAS No. 56 *Analytical Procedures* [See section 329]
 - SAS No. 57 *Auditing Accounting Estimates* [See section 342]
 - SAS No. 59 *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* [See section 341]
 - SAS No. 60 *Communication of Internal Control Structure Related Matters Noted in an Audit* [See section 325]
 - SAS No. 61 *Communications With Audit Committees* [See section 325]
- Effective for reports issued or reissued on or after January 1, 1989
 - SAS No. 58 *Reports on Audited Financial Statements* [See section 508]
- Effective for audits of financial statements for periods beginning on or after January 1, 1990
 - SAS No. 55 *Consideration of the Internal Control Structure in a Financial Statement Audit* [See section 319]

Since these SASs all have effective dates of 1989 or 1990, but permit early application, the superseded AU sections have been retained in this Appendix, along with their applicable interpretations.

SAS Nos. 53 through 61 also introduce auditing standards terminology, concepts and procedures that affect, and may require conforming changes to, other AU sections not superseded by the SASs listed above. The Auditing Standards Board expects to complete in September 1988 a review of **Professional Standards**, volume 1, to determine the nature and extent of the conforming changes required. The affected sections will then be updated in **Professional Standards** to reflect those conforming changes. Users of **Professional Standards** should be aware that there may be some inconsistencies between the sections which contain the new SASs and other sections.

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AU Appendix G

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[The next page is 2141.]

AU Section 318

Analytical Review Procedures

[Superseded by section 329.]

Sources: SAS No. 23; SAS No. 48.

See section 9329 for interpretations of this section.

Issue date, unless otherwise indicated: October, 1978.

.01 This section applies to analytical review procedures in an examination made in accordance with generally accepted auditing standards.¹ It provides guidance for consideration by the auditor when he applies such procedures, but no specific analytical review procedures are required by this section.

.02 Analytical review procedures are substantive tests of financial information made by a study and comparison of relationships among data. The auditor's reliance on substantive tests may be derived from tests of details of transactions and balances, from analytical review procedures, or from any combination of both. That decision is a matter of the auditor's judgment of the expected effectiveness and efficiency of the respective types of procedures (see section 320.82). [Reference changed by the issuance of Statement on Auditing Standards No. 43. Subsequently changed by the issuance of Statement on Auditing Standards No. 48.]

.03 A basic premise underlying the application of analytical review procedures is that relationships among data may reasonably be expected by the auditor to exist and continue in the absence of known conditions to the contrary. The presence of those relationships provides the auditor with evidential matter required by the third standard of field work. The application of analytical review procedures may indicate the need for additional procedures or may indicate that the extent of other auditing procedures may be reduced.

.04 When analytical review procedures identify fluctuations that are not expected, or the absence of fluctuations when they are expected, or other items that appear to be unusual, the auditor should investigate them if he believes that they are indicative of matters that have a significant effect on his examination.

Timing and Objectives of Analytical Review Procedures

.05 The timing of analytical review procedures will vary with the auditor's objectives. Analytical review procedures may be performed at various times during an examination:

¹ This section amends the first sentence of section 320.79 to read as follows:

The evidential matter required by the third standard is obtained through two general classes of auditing procedures: (a) tests of details of transactions and balances and (b) analytical review procedures applied to financial information.

[Reference changed by the issuance of Statement on Auditing Standards No. 43. Subsequently changed by the issuance of Statement on Auditing Standards No. 48.]

- a. In the initial planning stages to assist in determining the nature, extent, and timing of other auditing procedures by identifying, among other things, significant matters that require consideration during the examination.
- b. During the conduct of the examination in conjunction with other procedures applied by the auditor to individual elements of financial information.
- c. At or near the conclusion of the examination as an overall review of the financial information.

The Nature of Analytical Review Procedures

.06 Analytical review procedures include the following:

- a. Comparison of the financial information with information for comparable prior period(s).
- b. Comparison of the financial information with anticipated results (for example, budgets and forecasts).
- c. Study of the relationships of elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience.
- d. Comparison of the financial information with similar information regarding the industry in which the entity operates.
- e. Study of relationships of the financial information with relevant nonfinancial information.

Various methods may be used to perform these procedures. They may be made using dollars, physical quantities, ratios, or percentages. The methods selected by the auditor are a matter of his professional judgment.

.07 Analytical review procedures may be applied to overall financial information of the entity, to financial information of components such as subsidiaries or divisions, and to individual elements of financial information. The auditor should consider the following factors when planning and performing analytical review procedures.

- a. *The nature of the entity.* For example, an auditor performing an examination of a diversified entity may conclude that the application of analytical review procedures to the consolidated financial statements may not be as effective or efficient as the application of those procedures to the consolidated financial statements of a nondiversified entity.
- b. *The scope of the engagement.* For example, an examination of a specified element, account, or item of a financial statement may include fewer analytical review procedures than would an examination of financial statements.

- c. *The availability of financial information about the entity's financial position and results of operations.* Examples may include budgets and forecasts and detailed financial information about the entity's subsidiaries or divisions and interim periods.
- d. *The availability of relevant nonfinancial information.* Examples may include units produced or sold, number of employees, hours worked by nonsalaried personnel, and square feet of selling floor space, which may be related to financial information.
- e. *The increased availability of data prepared for management's use when computer processing is used.* Computer systems have created an ability (which may not be practical in manual systems) to store, retrieve, and analyze data for use in achieving broader management objectives. These data and analyses, although not necessarily part of the basic accounting records, may be valuable sources of information for the auditor to use in applying analytical review procedures, other substantive tests, or compliance testing.
- f. *The reliability of financial and nonfinancial information.* The auditor should consider the possibility that financial or nonfinancial information might not be reliable based on his knowledge of the entity, including his knowledge of the means by which the information is produced. In that connection, the auditor should consider knowledge obtained during previous examinations, the results of his study and evaluation of internal accounting control, and the results of his tests of details of transactions and balances. He should consider the types of matters that in preceding periods have required accounting adjustments. For example, the auditor may decide not to conduct certain analytical review procedures until near the completion of his examination if he is aware that trial balance amounts may require substantial adjustments; or he may decide to make only limited comparisons of actual and budgeted income and expense when the entity's budget is a motivational tool and not an estimate of the most probable financial position, results of operations, and changes in financial position.
- g. *The availability and comparability of financial information regarding the industry in which the entity operates.* The auditor should consider whether industry information, such as gross margin information, is reasonably available and current and whether data used to compile the information is comparable to the information being evaluated. For example, broad industry information may not be comparable to that of an entity that produces and sells specialized products.

[As amended, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

Investigating Significant Fluctuations

.08 The auditor should investigate fluctuations that are not expected, the absence of fluctuations that are expected, and other items that appear to be unusual that are identified by analytical review procedures when he believes that those fluctuations or unusual items are indicative of matters that have a

significant effect on his examination. When investigating such significant fluctuations, the auditor ordinarily would begin by making suitable inquiries of management. He would then (a) evaluate the reasonableness of replies to his inquiries by reference to his knowledge of the business and other information already obtained during the conduct of the examination and (b) consider the need to corroborate the replies to his inquiries by the application of other auditing procedures. If management is unable to provide an acceptable explanation of significant fluctuations, the auditor should perform additional procedures to investigate those fluctuations further.

.09 In deciding the nature and extent of procedures which should be used to investigate significant fluctuations, the auditor's consideration should include the following factors:

- a. *The objective of the analytical review procedures.* For example, the objective may be to assist the auditor in planning his examination by identifying areas that may need special consideration (such as identifying any significant increases in inventories by inventory locations). The extent to which the auditor decides to corroborate an explanation of a significant fluctuation in those circumstances depends on whether the resulting audit plan he develops would otherwise provide sufficient evidential matter.
- b. *The nature of the item.* For example, an auditor investigating a fluctuation in inventory turnover in a manufacturing company might corroborate a response to his inquiry by obtaining other evidential matter, such as evidence with respect to unusual quantities of inventories represented to be on hand at the date of the financial statements. Conversely, an auditor might limit to inquiries his investigation of a fluctuation in prepaid insurance for the same company.
- c. *The auditor's knowledge of the entity's business.* For example, the auditor may be aware of an extended strike by manufacturing employees during the year. He may conclude that this is a satisfactory explanation for a decline in sales volume and not apply other procedures to investigate this otherwise significant fluctuation.
- d. *The results of other auditing procedures.* For example, the auditor may decide not to apply other procedures to investigate an otherwise significant fluctuation in depreciation expense because he may already be aware of major additions or retirements from his tests of property transactions.
- e. *The auditor's study and evaluation of internal accounting control.* For example, the extent to which the auditor decides to corroborate an explanation of an increase in bad debt expense may vary depending on his evaluation of internal accounting control in the credit department.

.10 In his investigation of significant fluctuations, the auditor also should be alert to the possible effect of his findings on the scope of his examination of related accounts. For example, a finding that accounts receivable have

increased due to slow collections in a “tight money” environment may indicate the need for expanded tests of collectibility.

➡ *The next page is 2147.* ←

AU Section 320

The Auditor's Study and Evaluation of Internal Control

[Superseded by section 319.]

Sources: SAS No. 1, section 320; SAS No. 20; SAS No. 23; SAS No. 30; SAS No. 39; SAS No. 43; SAS No. 48.

See section 9320 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

Introduction

.01 The second standard of field work is:

There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

Experience has demonstrated the soundness of the basic concepts and rationale comprehended in this standard. The purpose of this section is to amplify and clarify the application of these concepts in the light of subsequent developments in business and in the profession.

.02 The increasing trend for certified public accountants to provide management advisory or consulting services involving the study, evaluation, and improvement of management information systems increases the need to clearly distinguish between these special services and those audit services required for compliance with the auditing standard for study and evaluation of internal control incident to an examination of financial statements.

.03 Also increasing is the trend toward integrating accounting information required for financial and other operating purposes into coordinated management information systems. This development increases the need to clearly identify the elements of the total system that are comprehended in the auditing standard concerning internal control. [Formerly paragraph .04 (old paragraph .03 deleted), number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.04 These developments and distinctions are important not only for the purposes of defining the nature and scope of the auditor's study and evaluation of internal control but also in clarifying any reports he may issue thereon. This need is accentuated by the increasing requests for reports on internal control for use by management or by regulatory agencies¹ and sometimes for inclusion in published reports. [Formerly paragraph .05, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

¹ As used here, regulatory agencies include both governmental and other agencies, such as stock exchanges, that exercise regulatory, supervisory, or other public administrative functions.

Purpose of Auditor's Study and Evaluation

.05 The purpose of the auditor's study and evaluation of internal control, as expressed in the auditing standard quoted in paragraph .01, is to establish a basis for reliance thereon in determining the nature, extent, and timing of audit tests to be applied in his examination of the financial statements. [Formerly paragraph .06, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.06 The study and evaluation made for this purpose frequently provide a basis for constructive suggestions to clients concerning improvements in internal control. [Formerly paragraph .07, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.07 Although auditors are interested in both of the foregoing aspects of their study and evaluation of internal control, it is important to recognize an essential difference between them. The study and evaluation contemplated by generally accepted auditing standards should be performed for each audit to the extent the auditor considers necessary for that purpose as discussed further herein. Although constructive suggestions to clients for improvements in internal control incident to an audit engagement are desirable,* the scope of any additional study made to develop such suggestions is not covered by generally accepted auditing standards. The scope of an auditor's study pursuant to a special engagement will depend on the terms of the engagement. [As modified, November 1979, by the Auditing Standards Board. Formerly paragraph .08, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Definitions and Basic Concepts

Previous Definitions

.08 In 1948 the Committee on Auditing Procedure made a comprehensive study of internal control and published its results in 1949 as a special report entitled *Internal Control—Elements of a Coordinated System and Its Importance to Management and the Independent Public Accountant*. In that special report, internal control was defined as follows:

Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognizes that a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments.

[Formerly paragraph .09, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.09 To clarify the scope of the auditor's review as it pertains to his examination leading to the expression of an opinion on financial statements,

* If the auditor is aware of a material weakness in internal accounting control, a communication as described in section 323, *Required Communication of Material Weaknesses in Internal Accounting Control*, is required.

the Committee issued Statement on Auditing Procedure No. 29 in October 1958, which subdivided internal control as follows:

Internal control, in the broad sense includes . . . controls which may be characterized as either accounting or administrative as follows:

a. Accounting controls comprise the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, the safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing.

b. Administrative controls comprise the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls.

[Formerly paragraph .10, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.10 The foregoing subdivision of internal control into accounting controls and administrative controls was made for the purpose of clarifying the scope of study contemplated under generally accepted auditing standards. The Committee's conclusions in that respect, incorporated in Chapter 5 of Statement No. 33 in 1963, were as follows:

The independent auditor is primarily concerned with the accounting controls. Accounting controls . . . generally bear directly and importantly on the reliability of financial records and require evaluation by the auditor. Administrative controls . . . ordinarily relate only indirectly to the financial records and thus would not require evaluation. If the independent auditor believes, however, that certain administrative controls may have an important bearing on the reliability of the financial records, he should consider the need for evaluating such controls. For example, statistical records maintained by production, sales, or other operating departments may require evaluation in a particular instance.

[Formerly paragraph .11, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.11 The overriding criterion inherent in the preceding excerpt is the bearing which particular controls have on the reliability of financial statements, regardless of their classification as accounting or administrative controls. For practical purposes, this is tantamount to including within the definition of accounting controls any administrative controls that have an important bearing on the reliability of the financial statements; consequently, this concept is adopted in the revised definitions in this section. [Formerly paragraph .12, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Need for Clarification

.12 Clarification of the previous definition of accounting control is desirable because of possible differences in interpretation with respect to the two key elements comprehended in it: the safeguarding of assets and the reliability of financial records. These differences and the Committee's conclusions con-

cerning them are discussed in the following paragraphs. [Formerly paragraph .13, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Safeguarding of Assets

.13 One meaning of "safeguarding" that appears relevant in the context of the previous definition of accounting control is "a means of protection against something undesirable."² Use of this definition conceivably could lead to a broad interpretation that the protection of existing assets and acquisition of additional assets is the primary function of management and, therefore, that any procedures or records entering into management's decision-making processes are comprehended in this element of the definition. Under this concept, for example, a management decision to sell a product at a price that proves to be unprofitable might be regarded as a failure to protect existing assets and, therefore, as evidence of inadequate accounting control. The same interpretation might be applied to a decision to incur expenditures for equipment that proves to be unnecessary or inefficient, for materials that prove to be unsatisfactory in production, for merchandise that proves to be unsaleable, for research that proves to be unproductive, for advertising that proves to be ineffective, and to similar management decisions. [Formerly paragraph .14, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.14 A second possible interpretation is that safeguarding of assets refers only to protection against loss arising from intentional and unintentional errors in processing transactions and handling the related assets. Unintentional errors include such as the following: understatement of sales through failure to prepare invoices or through incorrect pricing or computation; overpayments to vendors or employees arising from inaccuracies in quantities of materials or services, prices or rates, or computations; and physical loss of assets such as cash, securities, or inventory. In some situations, unintentional errors might also include improper allocations of certain costs, which would result in failure to recover these costs from customers. [Formerly paragraph .15, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.15 A third possible interpretation is that safeguarding of assets refers only to protection against loss arising from intentional errors. These include defalcations and similar irregularities, and the latter includes falsification of records for the purpose of causing improper computation of commissions, profit-sharing bonuses, royalties, and similar payments based on the recording of other transactions. [Formerly paragraph .16, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Reliability of Financial Records

.16 Possible differences in interpretation concerning the reliability of financial records as used in the previous definition of accounting control arise from the two separate purposes for which the financial records may be used: internal management and external reporting. One interpretation would extend the scope of accounting control to include reliability of the financial records for both of these purposes, while another would restrict it to external reporting purposes only. [Formerly paragraph .17, number changed by issuance of

² Webster's Third New International Dictionary of the English Language Unabridged (1961), page 1998.

Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.17 To illustrate the foregoing distinction, the degree and accuracy of classifications, details, and allocations required to provide reliability of records for such internal management purposes as establishing sales policies and prices, estimating future costs, and measuring performance by divisions, products, or other lines of responsibility ordinarily are greater than those required to provide reliability for external reporting purposes. [Formerly paragraph .18, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Flow of Transactions

.18 The Committee believes the previous definition of accounting control extended only to the safeguarding of assets against loss from unintentional or intentional errors or irregularities (see paragraph .14) and to the reliability of financial records for external reporting purposes (see paragraph .16). A revised definition expressed in relation to the functions involved in the flow of transactions is presented in paragraph .27 to provide the clarification needed in this respect. [Formerly paragraph .19, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.19 Transactions are the basic components of business operations and, therefore, are the primary subject matter of internal control. In the context of this section, transactions include exchanges of assets or services with parties outside the business entity and transfers or use of assets or services within it. The primary functions involved in the flow of transactions and related assets include the authorization, execution, and recording of transactions and the accountability for resulting assets. [Formerly paragraph .20, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.20 The ultimate authority for business transactions rests with stockholders or other classes of owners except as circumscribed by law and is delegated by them to directors, trustees, officers, and other management personnel. The delegation of authority to different levels and to particular persons in an organization is a management function. As used herein, authorization of transactions refers to management's decision to exchange, transfer, or use assets for specified purposes under specified conditions. [Formerly paragraph .21, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.21 Authorization may be general in that it relates to any transactions that conform to the specified conditions, or it may be specific with reference to a single transaction. Examples of general authorization include the establishment of sales prices for products to be sold to any customer, requirements to be met in setting the credit limit for any customer, automatic reorder points for material or merchandise, the number and type of personnel to be employed, and similar decisions. The basic characteristic of general authorization is that it is concerned with the definition or identification of the general conditions under which transactions are authorized without regard to the specific parties or transactions. Specific authorization, on the other hand, comprehends both the conditions and the parties involved; examples include authorizations for a specific sale or purchase, the employment of a specific person, the use of specific materials or employees for a particular production order, and similar

transactions. [Formerly paragraph .22, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.22 Execution of transactions includes the entire cycle of steps necessary to complete the exchange of assets between the parties or the transfer or use of assets within the business. The execution of transactions frequently involves separate steps or stages. For example, the typical sale would involve acceptance of an order, shipment and billing of the product, and collection of the billing. A similar cycle of steps for the typical purchase of material or services may include requisitioning of the material, issuance of the order, receipt of the material, and payment of the purchase price. In this section, authorization applies to the complete cycle of steps; authorization is distinguished from approval in that the latter applies to a particular step and indicates only that the conditions specified or implied in the authorization have been satisfied insofar as they apply to that step. [Formerly paragraph .23, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.23 Recording of transactions comprehends all records maintained with respect to the transactions and the resulting assets or services and all functions performed with respect to such records. Thus, the recording of transactions includes the preparation and summarization of records and the posting thereof to the general ledger and subsidiary ledgers. [Formerly paragraph .24, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.24 The accountability function follows assets from the time of their acquisition in one transaction until their disposition or use in another. This function requires maintenance of records of accountability for assets and periodic comparison of these records with the related assets. Examples include the reconciliation of recorded cash balances with bank statements and reconciliation of perpetual inventory with physical inventory counts. [Formerly paragraph .25, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Revised Definitions

.25 Based on the foregoing discussion, administrative control and accounting control are defined as indicated in the following two paragraphs. [Formerly paragraph .26, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.26 *Administrative control* includes, but is not limited to, the plan of organization and the procedures and records that are concerned with the decision processes leading to management's authorization of transactions.³ Such authorization is a management function directly associated with the responsibility for achieving the objectives of the organization and is the starting point for establishing accounting control of transactions. [Formerly paragraph .27, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.27 *Accounting control* comprises the plan of organization and the procedures and records that are concerned with the safeguarding of assets and the

³ This definition is intended only to provide a point of departure for distinguishing accounting control and, consequently, is not necessarily definitive for other purposes.

reliability of financial records and consequently are designed to provide reasonable assurance that:

- a. Transactions are executed in accordance with management's general or specific authorization.
- b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- c. Access to assets is permitted only in accordance with management's authorization.
- d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

[Formerly paragraph .28, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.28 The foregoing definitions are not necessarily mutually exclusive because some of the procedures and records comprehended in accounting control may also be involved in administrative control. For example, sales and cost records classified by products may be used for accounting control purposes and also in making management decisions concerning unit prices or other aspects of operations. Such multiple uses of procedures or records, however, are not critical for the purposes of this section because it is concerned primarily with clarifying the outer boundary of accounting control. Examples of records used solely for administrative control are those pertaining to customers contacted by salesmen and to defective work by production employees maintained only for evaluating personnel performance. [Formerly paragraph .29, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Basic Concepts

.29 The basic concepts discussed under this caption are implicit in the definition of accounting control. (The discussion in paragraphs .30 through .35 applies to the definition generally, while the discussion in paragraphs .36 through .49 applies to essential characteristics of internal accounting control.) These concepts are applicable generally, but the organizational and procedural means of applying them may differ considerably from case to case because of the variety of circumstances involved. Therefore, it is not considered feasible to discuss these matters in detail in this section. [Formerly paragraph .30, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Management Responsibility

.30 The establishment and maintenance of a system of internal control is an important responsibility of management. The basic concepts implicit in the definition of accounting control are discussed in the context of that responsibility. The system of internal control should be under continuing supervision by management to determine that it is functioning as prescribed and is modified as appropriate for changes in conditions. [Formerly paragraph .31, number

changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Reasonable Assurance

.31 The definition of accounting control comprehends reasonable, but not absolute, assurance that the objectives expressed in it will be accomplished by the system. The concept of reasonable assurance recognizes that the cost of internal control should not exceed the benefits expected to be derived. The benefits consist of reductions in the risk of failing to achieve the objectives implicit in the definition of accounting control. Although the cost-benefit relationship is the primary conceptual criterion that should be considered in designing a system of accounting control, precise measurement of costs and benefits usually is not possible; accordingly, any evaluation of the cost-benefit relationship requires estimates and judgments by management. Because of the cost-benefit relationship, accounting control procedures may appropriately be applied on a test basis in some circumstances. [Formerly paragraph .32, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Methods of Data Processing

.32 Since the definition and related basic concepts of accounting control are expressed in terms of objectives, they are independent of the method of data processing used; consequently, they apply equally to manual, mechanical, and electronic data processing systems. However, the organization and procedures required to accomplish those objectives may be influenced by the method of data processing used. [Formerly paragraph .33, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.33 The methods an entity uses to process significant accounting applications may influence the control procedures designed to achieve the objectives of internal accounting control. Those characteristics that distinguish computer processing from manual processing include—

- a. *Transaction trails.*⁴ Some computer systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer-readable form.
- b. *Uniform processing of transactions.* Computer processing uniformly subjects like transactions to the same processing instructions. Consequently, computer processing virtually eliminates the occurrence of clerical error normally associated with manual processing. Conversely, programming errors (or other similar systematic errors in either the computer hardware or software) will result in all like transactions being processed incorrectly when those transactions are processed under the same conditions.
- c. *Segregation of functions.* Many internal accounting control procedures once performed by separate individuals in manual systems may be concentrated in systems that use computer processing. Therefore, an individual who has access to the computer may be in a position to perform incompatible functions. As a result, other control

⁴ A transaction trail is a chain of evidence provided through coding, cross references, and documentation connecting account balances and other summary results with original transactions and calculations. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

procedures may be necessary in computer systems to achieve the control objectives ordinarily accomplished by segregation of functions in manual systems. Other controls may include, for example, adequate segregation of incompatible functions within the computer processing activities, establishment of a control group to prevent or detect processing errors or irregularities, or use of password control procedures to prevent incompatible functions from being performed by individuals who have access to assets and access to records through an on-line terminal.

- d. *Potential for errors and irregularities.* The potential for individuals, including those performing control procedures, to gain unauthorized access to data or alter data without visible evidence, as well as to gain access (direct or indirect) to assets, may be greater in computerized accounting systems than in manual systems. Decreased human involvement in handling transactions processed by computers can reduce the potential for observing errors and irregularities. Errors or irregularities occurring during the design or changing of application programs can remain undetected for long periods of time.
- e. *Potential for increased management supervision.* Computer systems offer management a wide variety of analytical tools that may be used to review and supervise the operations of the company. The availability of these additional controls may serve to enhance the entire system of internal accounting control on which the auditor may wish to place reliance. For example, traditional comparisons of actual operating ratios with those budgeted, as well as reconciliations of accounts, are frequently available for management review on a more timely basis if such information is computerized. Additionally, some programmed applications provide statistics regarding computer operations that may be used to monitor the actual processing of transactions.
- f. *Initiation or subsequent execution of transactions by computer.* Certain transactions may be automatically initiated or certain procedures required to execute a transaction may be automatically performed by a computer system. The authorization of these transactions or procedures may not be documented in the same way as those initiated in a manual accounting system, and management's authorization of those transactions may be implicit in its acceptance of the design of the computer system.⁵
- g. *Dependence of other controls on controls over computer processing.* Computer processing may produce reports and other output that are used in performing manual control procedures. The effectiveness of these manual control procedures can be dependent on the effectiveness of controls over the completeness and accuracy of computer processing. For example, the effectiveness of a control procedure

⁵ To the extent that the computer is used to initiate transactions or execute procedures, the application program usually includes procedures designed to assure that the steps are executed in conformity with specific or general authorizations issued by management acting within the scope of its authority. Those procedures might include checks to recognize data that fall outside predetermined limits and tests for overall reasonableness. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

that includes a manual review of a computer-produced exception listing is dependent on the controls over the production of the listing.

[New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.34 Where computer processing is used in significant accounting applications, internal accounting control procedures are sometimes defined by classifying control procedures into two types: general and application control procedures.⁶ Whether the control procedures are classified by the auditor into general and application controls, the objective of the system of internal accounting control remains the same: to provide reasonable, but not absolute, assurance that assets are safeguarded from unauthorized use or disposition and that financial records are reliable to permit the preparation of financial statements. [New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

Limitations

.35 There are inherent limitations that should be recognized in considering the potential effectiveness of any system of accounting control. In the performance of most control procedures, there are possibilities for errors arising from such causes as misunderstanding of instructions, mistakes of judgment, and personal carelessness, distraction, or fatigue. Furthermore, procedures whose effectiveness depends on segregation of duties obviously can be circumvented by collusion. Similarly, procedures designed to assure the execution and recording of transactions in accordance with management's authorizations may be ineffective against either errors or irregularities perpetrated by management with respect to transactions or to the estimates and judgments required in the preparation of financial statements. In addition to the limitations discussed above, any projection of a current evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with the procedures may deteriorate. [Formerly paragraph .34, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Personnel

.36 Reasonable assurance that the objectives of accounting control are achieved depends on the competence and integrity of personnel, the independence of their assigned functions, and their understanding of the prescribed procedures. Although these factors are important, their contribution is to provide an environment conducive to accounting control rather than to provide assurance that it necessarily will be achieved. Accounting control procedures may be performed by personnel in any appropriate organizational position. In smaller organizations such procedures may be performed by the owner-manager. In these circumstances, however, some of the limitations discussed in paragraph .35 may be particularly applicable. [Formerly paragraph .35, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

⁶ General controls are those controls that relate to all or many computerized accounting activities and often include control over the development, modification, and maintenance of computer programs and control over the use of and changes to data maintained on computer files. Application controls relate to individual computerized accounting applications, for example, programmed edit controls for verifying customers' account numbers and credit limits. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

Segregation of Functions

.37 Incompatible functions for accounting control purposes are those that place any person in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties.⁷ Anyone who records transactions or has access to assets ordinarily is in a position to perpetrate errors or irregularities. Accordingly, accounting control necessarily depends largely on the elimination of opportunities for concealment. For example, anyone who records disbursements could omit the recording of a check, either unintentionally or intentionally. If the same person also reconciles the bank account, the failure to record the check could be concealed through an improper reconciliation. In an accounting system using a computer to print checks and record disbursements, the computer may also generate information used to reconcile the account balance. If the same person entering information into the computer to execute the payment process also receives the output for the reconciliation process, a similar failure could be concealed. These examples illustrate the concept that procedures designed to detect errors and irregularities should be performed by persons other than those who are in a position to perpetrate them; that is, these procedures should be performed by persons having no incompatible functions. Procedures performed by such persons are described hereinafter as being performed independently. [Formerly paragraph .36, as amended, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

Execution of Transactions

.38 Obtaining reasonable assurance that transactions are executed as authorized requires independent evidence that authorizations are issued by persons acting within the scope of their authority and that transactions conform with the terms of the authorizations. These terms may be either explicit or implicit, the latter being in the form of company policies or usual business practices applicable to the transactions involved. In some cases the required evidence is obtained by independent comparison of transaction documents with specific authorizations. For example, receiving reports and vendors' invoices may be compared with purchase orders in approving vouchers for payments; further, paid checks may be compared with approved vouchers, either individually or collectively, through reconciliations and related procedures. In other cases, such comparisons may be made with general authorizations such as general price lists, credit policies, or automatic reorder points. Such comparisons may be made manually or by computers. Reasonable assurance may sometimes be obtained by comparison of recorded transactions with budgets or standard costs, but the effectiveness of this alternative depends on the extent to which variations are identified and investigated. In some cases the only practicable means for obtaining reasonable assurance is by periodic surveillance of the personnel engaged in the execution of transactions. [Formerly paragraph .37, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Recording of Transactions

.39 The objective of accounting control with respect to the recording of transactions requires that they be recorded at the amounts and in the accounting periods in which they were executed and be classified in appropri-

⁷ In this section "errors" refers to unintentional mistakes, and "irregularities" refers to intentional distortions of financial statements and to defalcations. [Footnote renumbered by issuance of Statement on Auditing Standards No. 48.]

ate accounts. For this purpose accounting periods refer to the periods for which financial statements are to be prepared. In the definition of accounting control this objective is expressed in terms of permitting, rather than assuring, the preparation of financial statements in conformity with generally accepted accounting principles or any other applicable criteria. This distinction recognizes that, beyond the necessary recording of transactions, management's judgment is required in making estimates and other decisions required in the preparation of such statements. [Formerly paragraph .38, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.40 The possibilities for obtaining assurance that transactions have been properly recorded depend largely on the availability of some independent source of information that will provide an indication that the transactions have been executed. These possibilities vary widely with the nature of the business and the transactions, as illustrated by the following examples. At one extreme, comparison of paid checks returned by a bank with the recorded disbursements would reveal any unrecorded paid checks. Similarly, examination of documents supporting recorded disbursements would reveal those for which an accountability for resulting assets should be recorded concurrently. Where shipping documents are used, comparison of such documents with sales records would reveal unrecorded sales. A more indirect possibility with respect to sales is to estimate the aggregate amount that should be recorded by applying sales prices or gross profit rates to quantities or costs of inventory disposed of during a period. The degree of accuracy from such estimates depends on the variability of the pricing structure, the product mix, and other circumstances; in any event, however, such estimates ordinarily would not provide specific identification of any unrecorded sales that may be indicated. Assurance that collections on receivables are recorded rests primarily on the controls exercised over the records of receivables since these show the aggregate accountability for such collections. Accountability for collections of interest and dividends ordinarily can be established readily from securities records and independent published sources, while that for contributions from the general public ordinarily is more difficult to establish or estimate. The foregoing examples are not intended to be comprehensive in scope nor exhaustive in treatment but only illustrative of the general nature of the concepts and the variety of circumstances involved in obtaining assurance that transactions are properly recorded. [Formerly paragraph .39, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.41 Transactions with outside parties are necessarily recorded individually and should be recorded as promptly as practicable when the recording is necessary to maintain accountability for assets such as cash, securities, and others that are susceptible to loss from errors or irregularities. In this context, recording refers to the initial record, document, or copy evidencing the transaction and not to subsequent summarization. As to such summarization and as to the initial recording of other transactions, the time of recording within the appropriate accounting period may be determined on the basis of convenience and processing efficiency. [Formerly paragraph .40, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.42 The foregoing timing considerations apply also to the recording of internal transfers or use of assets or services. However, some transfers and cost allocations need not be recorded individually if the aggregate amounts can be determined satisfactorily. For example, cost of sales may be determined by

applying gross profit rates to sales, and material usage may be determined by reference to production reports and bills of material. [Formerly paragraph .41, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Access to Assets

.43 The objective of safeguarding assets requires that access to assets be limited to authorized personnel. In this context, access to assets includes both direct physical access and indirect access through the preparation or processing of documents that authorize the use or disposition of assets. Access to assets is required, of course, in the normal operations of a business and, therefore, limiting access to authorized personnel is the maximum constraint that is feasible for accounting control purposes in this respect. The number and caliber of personnel to whom access is authorized should be influenced by the nature of the assets and the related susceptibility to loss through errors and irregularities. Limitation of direct access to assets requires appropriate physical segregation and protective equipment or devices. Limitation of indirect access requires procedures similar to those discussed in paragraph .37. [Formerly paragraph .42, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Comparison of Recorded Accountability With Assets

.44 The purpose of comparing recorded accountability with assets is to determine whether the actual assets agree with the recorded accountability, and, consequently, it is closely related to the foregoing discussion concerning the recording of transactions. Typical examples of this comparison include cash and securities counts, bank reconciliations, and physical inventories. [Formerly paragraph .43, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.45 If the comparison reveals that the assets do not agree with the recorded accountability, it provides evidence of unrecorded or improperly recorded transactions. The converse, however, does not necessarily follow. For example, agreement of a cash count with the recorded balance does not provide evidence that all cash received has been properly recorded. This illustrates an unavoidable distinction between fiduciary and recorded accountability: the former arises immediately upon acquisition of an asset; the latter arises only when the initial record of the transaction is prepared. [Formerly paragraph .44, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.46 As to assets that are susceptible to loss through errors or irregularities, the comparison with recorded accountability should be made independently. [Formerly paragraph .45, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.47 The frequency with which such comparison should be made for the purpose of safeguarding assets depends on the nature and amount of the assets involved and the cost of making the comparison. For example, it may be reasonable to count cash daily but not reasonable to take a physical inventory at that interval. However, a daily inventory of products in the custody of route salesmen, for example, may be practicable as a means of determining their accountability for sales. Similarly, the value and vulnerability of some

products may make frequent complete inventories worthwhile. [Formerly paragraph .46, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.48 The frequency with which the comparison of recorded accountability with assets should be made for the purpose of achieving reliability of the records for preparing financial statements depends on the materiality of the assets and their susceptibility to loss through errors or irregularities. [Formerly paragraph .47, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.49 The action that may be appropriate with respect to any discrepancies revealed by the comparison of recorded accountability with assets will depend primarily on the nature of the asset, the system in use, and the amount and cause of the discrepancy. Appropriate action may include adjustment of the accounting records, filing of insurance claims, revision of procedures, or administrative action to improve the performance of personnel. [Formerly paragraph .48, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Study of System

Scope of Study

.50 As defined in paragraphs .26 through .28, accounting control is within the scope of the study and evaluation of internal control contemplated by generally accepted auditing standards, while administrative control is not. [As amended, effective after August 31, 1982 by Statement on Auditing Standards No. 43. Subsequently, paragraph .49 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.51 The study to be made as the basis for the evaluation of internal control includes two parts: (a) knowledge and understanding of the procedures and methods prescribed and (b) a reasonable degree of assurance that they are in use and are operating as planned. These two parts of the study are referred to as the review of the system and tests of compliance, respectively. Although these parts are discussed separately, they are closely related in that some portions of each may be performed concurrently and may contribute to the auditor's evaluation of the prescribed procedures and of the compliance with them. [As amended, effective after August 31, 1982 by Statement on Auditing Standards No. 43. Subsequently, paragraph .50, renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Review of System

.52 The purpose of the review of the system is to obtain sufficient knowledge and understanding about the accounting system and the internal accounting control system: (a) to make a determination of whether there are internal accounting control procedures that may provide a basis for reliance thereon in determining the nature, extent, and timing of substantive tests; or (b) to aid the auditor in designing substantive tests in the absence of such reliance.⁸ [As amended, effective after August 31, 1982, by Statement on

⁸ The accounting system is distinguishable from the system of internal accounting control. An accounting system comprises the coordinate functions by which exchanges of assets or services

Auditing Standards No. 43. Subsequently, paragraph .51 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.53 The preliminary phase of such a review should be designed to provide the auditor with an understanding of the control environment and the flow of transactions through the accounting system. An understanding of the control environment should provide the auditor with a general knowledge of such matters as the organizational structure, the methods used by the entity to communicate responsibility and authority, and the methods used by management to supervise the system, including the existence of an internal audit function, if any. An understanding of the flow of transactions should provide the auditor with a general knowledge of the various classes of transactions and the methods by which each significant class of transactions is authorized, executed, initially recorded, and subsequently processed, including the methods of data processing. The auditor's understanding ordinarily is obtained by a combination of previous experience with the entity, inquiry, observation, and reference to prior-year working papers, client-prepared descriptions of the system, or other appropriate documentation. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43. Subsequently, paragraph .52 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.54 On completion of the preliminary phase of the review, an auditor may conclude that further study and evaluation are unlikely to justify any restriction of substantive tests. An auditor also may conclude that the audit effort required to study and evaluate the design of the system and to test compliance with the prescribed control procedures to justify reliance on them to restrict the extent of substantive tests exceeds the reduction in audit effort that could be achieved by such reliance. Such a conclusion may result from consideration of the nature or amount of the transactions or balances involved, the data processing methods being used, and the auditing procedures that can be applied in making substantive tests. Either conclusion would cause an auditor to discontinue further study and evaluation of the internal accounting control system and to design substantive tests that do not contemplate reliance on such internal accounting control procedures.⁹ [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43. Subsequently, paragraph .53 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.55 If after the completion of the preliminary phase of the review the auditor does not plan to rely on the system to restrict substantive tests, his documentation may be limited to a record of his reasons for deciding not to extend his review. He need not document his understanding of the internal accounting control system; for example, he need not complete an internal control questionnaire. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43. Subsequently, paragraph .54 renum-

(Footnote Continued)

with parties outside the business entity and transfers or use of assets or services within it are recognized, and data representing such exchanges, transfers, and uses are assembled, processed, analyzed, and reported. The system of internal accounting control comprises the plan of organization and the procedures and records that are concerned with the safeguarding of assets and with the reliability of financial records produced by the accounting system. The objectives of internal accounting control are described in section 320.27. [Footnote renumbered by issuance of Statement on Auditing Standards No. 48.]

⁹ Section 326, *Evidential Matter*, paragraph .11, provides guidance on the design of substantive tests. [Footnote renumbered by issuance of Statement on Auditing Standards No. 48.]

bered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.56 If after the completion of the preliminary phase of the review the auditor plans to rely on the system of internal accounting control, he should complete the review of the system to determine whether the accounting control procedures are suitably designed to provide reasonable assurance that they will prevent or detect errors or irregularities. The auditor should consider the effectiveness of the specific control procedures, either individually or in combination, in terms of their significance to the prevention or detection of particular types of errors or irregularities concerning particular classes of transactions or balances. If one or more specific control procedures are adequate to prevent or detect a particular type of error or irregularity, the auditor need not consider other procedures. The absence or the inadequacy of one specific control procedure designed to prevent or detect a particular type of error or irregularity may not be a weakness if other specific control procedures achieve the same purpose. The information required for the review of the design of the system ordinarily is obtained through one or more of the following procedures: inquiries of appropriate client personnel, inspection of written documentation, and observation of the processing of transactions and the handling of related assets. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43. Subsequently, paragraph .55 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.57 Control procedures that achieve or contribute to the achievement of one or more specific control objectives are often interdependent. Some control procedures may be essential to the operation of other control procedures that meet specific control objectives (that is, they need to be functioning adequately for the achievement of those specific control objectives). In an accounting system that uses computer processing, the auditor's concern over the interdependence of control procedures may be greater than in a manual system because of the increased concentration of functions within the operations of computer processing. [New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.58 Control procedures that are designed to contribute to the achievement of specific control objectives, through their interdependence with specific control procedures, may be classified as general control procedures. Control procedures that are designed to achieve specific control objectives may be classified as application control procedures. Application controls are often dependent on general controls. For example, if an application control procedure, such as matching shipping information with billing information, were to be performed by a customer-billing computer program, the auditor might review the controls over the access to and changing of computer programs before reviewing this programmed control procedure or other programmed application control procedures. The adequacy of this programmed application control procedure is dependent on the adequacy of control procedures that ensure unauthorized changes have not been made to the computer program performing those procedures during the period under review. Accordingly, it may be more efficient to review the design of internal accounting control procedures that are essential to the operation of several specific control procedures before reviewing those specific control procedures. [New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.59 To clarify his understanding of information obtained from such sources, the auditor may trace one or a few of the different types of transactions involved through the related documents and records and observe the related internal accounting control procedures in operation. This practice may, if properly designed, be considered as a part of the tests of compliance, as discussed later in this section. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43. Subsequently, paragraph .56 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.60 On completion of the review of the design of the system, the auditor should make a preliminary evaluation of whether specific control procedures are suitably designed for him to rely on them for his purpose, assuming satisfactory compliance with those prescribed control procedures. Concepts to be considered in making either a preliminary or final evaluation are discussed in paragraphs .73 through .77. If control procedures are not suitably designed for the auditor to rely on them for his purpose, he would not test compliance with those controls, and he would design substantive tests that do not contemplate reliance on such internal accounting control procedures. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43. Subsequently, paragraph .57 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.61 The extent of the auditor's documentation of the review depends on his anticipated reliance on internal accounting controls, the nature of the entity's system, and the entity's documentation of that system. The auditor should document his understanding of the system and the basis for his conclusion that the internal accounting control procedures on which he intends to rely are suitably designed to provide reasonable assurance that those procedures will prevent or detect particular types of errors or irregularities concerning particular classes of transactions or balances. The auditor may document his understanding of the system and his conclusions about the design of that system in the form of answers to a questionnaire, narrative memorandums, flowcharts, decision tables, or any other form that the auditor considers appropriate in the circumstances. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43. Subsequently, paragraph .58 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Tests of Compliance

.62 The purpose of compliance tests is to provide reasonable assurance that the accounting control procedures are being applied as prescribed. Such tests are necessary if the prescribed procedures are to be relied on in determining the nature, timing, or extent of substantive tests of particular classes of transactions or balances, as discussed later in paragraphs .64 through .72, but are not necessary if the procedures are not to be relied on for that purpose. The discussion of compliance tests in the remainder of this section applies only to those portions of the system of internal accounting control on which the auditor will rely in determining the nature, timing, and extent of substantive tests. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43. Subsequently, paragraph .59 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.63 The nature of accounting control procedures and of the available evidence of compliance necessarily determines the nature of the tests of compliance and also influences the timing and extent of such tests as discussed under the respective captions that follow. Although tests of compliance are discussed separately under these captions, they are closely interrelated with substantive tests as discussed in paragraph .79; in practice, auditing procedures often concurrently provide evidence of compliance with accounting control procedures as well as evidence required for substantive purposes. [Formerly paragraph .56, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .60 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Nature of Tests

.64 Accounting control requires not only that certain procedures be performed but that they be performed properly and independently. Tests of compliance, therefore, are concerned primarily with these questions: Were the necessary procedures performed, how were they performed, and by whom were they performed? [Formerly paragraph .57, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .61 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.65 Some aspects of accounting control require procedures that are not necessarily required for the execution of transactions. This class of procedures includes the approval or independent review of documents evidencing transactions. In a manual processing system the evidence of performing those procedures may be supported by those transaction documents because the individual assigned to perform that control procedure is normally required to indicate approval (for example, by initialing the document). If an accounting application is processed by computer, however, those procedures performed by an application program frequently will not provide visible evidence of those procedures and may not be performed independently of the original processing of transactions. [Formerly paragraph .58, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .62 renumbered and amended, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.66 Tests of such procedures performed manually require inspection of the related documents (a) to obtain evidence in the form of signatures, initials, audit stamps, and the like; (b) to indicate whether the procedures were performed, and by whom; and (c) to permit an evaluation of the propriety of their performance. Tests of such procedures performed by a computer may be made in a similar manner, provided that the computer produces visible evidence (a) to verify that the procedures were in operation and (b) to evaluate the propriety of their performance. For example, a computer-generated error list may provide such evidence if the list is tested by comparison to a list of the transaction file used by the same application program. If such evidence is not generated by the computer, those control procedures may be tested by using computer-assisted audit techniques to reperform the processing of the relevant information and then comparing the results of reperformance with the actual results. Another method may be submission of test data to the same computer process. It is important to understand that tests designed to verify the operation of programmed control procedures can be effective only if the auditor can obtain reasonable assurance of the consis-

tency of their operation throughout the period under examination. Reasonable assurance may be obtained by testing controls over the maintenance and processing of those programs or from alternative procedures such as testing the programmed control procedures throughout the period. [New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.67 Other aspects of accounting control require a segregation of duties so that certain procedures are performed independently, as discussed in paragraph .37 (as amended above). The performance of these procedures is largely self-evident from the operation of the business or the existence of its essential records; consequently, tests of compliance with such procedures are primarily to determine whether the procedures were performed by persons having no incompatible functions. This is true for both manual and computerized accounting systems. Examples of this class of procedures may include (a) the receiving, depositing, and disbursing of cash; (b) the recording of transactions; and (c) the posting of customers' accounts. Since such procedures frequently leave no audit trail of who performed them, tests of compliance in these situations are necessarily limited to inquiries of different personnel and observation of office personnel and routines to corroborate the information obtained during the review of the system. While reconciliations, confirmations, or other audit tests performed in accordance with the auditing standards relating to evidential matter may substantiate the accuracy of the underlying records, these tests frequently provide no affirmative evidence of segregation of duties because the records may be accurate even though maintained by persons having incompatible functions. [Formerly paragraph .59, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .63 renumbered and amended, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.68 In a computerized accounting system, functions that would be incompatible in a manual system are often performed by computer. Individuals who have access to computer operations may then be in a position to perpetrate or conceal errors or irregularities. This need not be a weakness if there are control procedures that prevent such an individual from performing incompatible functions within the accounting system. These control procedures might include (a) adequate segregation of incompatible functions within the data processing department, (b) segregation between data processing and user department personnel performing review procedures, and (c) adequate control over access to data and computer programs. [New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

Timing and Extent of Tests

.69 As indicated in paragraph .51, the purpose of tests of compliance with accounting control procedures is to provide "a reasonable degree of assurance that they are in use and are operating as planned." What constitutes a "reasonable" degree of assurance is a matter of auditing judgment; the "degree of assurance" necessarily depends on the nature, timing, and extent of the tests and on the results obtained. [Formerly paragraph .60, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .64 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

➡ **The next page is 2167.** ⬅

.70 As to accounting control procedures that leave an audit trail of documentary evidence of compliance, tests of compliance as described in paragraph .65 ideally should be applied to transactions executed throughout the period under audit because of the general sampling concept that the items to be examined should be selected from the entire set of data to which the resulting conclusions are to be applied. Independent auditors often make such tests during interim work. When this has been done, application of such tests throughout the remaining period may not be necessary. Factors to be considered in this respect include (a) the results of the tests during the interim period, (b) responses to inquiries concerning the remaining period, (c) the length of the remaining period, (d) the nature and amount of the transactions or balances involved, (e) evidence of compliance within the remaining period that may be obtained from substantive tests performed by the independent auditor or from tests performed by internal auditors, and (f) other matters the auditor considers relevant in the circumstances. [Formerly paragraph .61, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .65 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.71 Tests of compliance may be applied on either a nonstatistical or statistical basis. Statistical sampling may be a practical means for expressing in quantitative terms the auditor's judgment concerning reasonableness and for determining sample size and evaluating sample results on that basis. [As modified by the issuance of SAS No. 39.] (See section 350.) [Formerly paragraph .62, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .66 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.72 As to accounting control procedures that depend primarily on segregation of duties and leave no audit trail, the inquiries described in paragraph .67 should relate to the entire period under audit, but the observations described therein ordinarily may be confined to the periods during which the auditor is present on the client's premises in conducting other phases of his audit. [Formerly paragraph .63, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .67 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Evaluation of System

.73 From the viewpoint of management, the purposes of accounting control are stated in the definition given previously. These purposes apply equally to the independent auditor, but they were stated somewhat differently in Chapter 5 of Statement No. 33 as follows:

A function of internal control, from the viewpoint of the independent auditor, is to provide assurance that errors and irregularities may be

discovered with reasonable promptness, thus assuring the reliability and integrity of the financial records. The independent auditor's review of the system of internal control assists him in determining other auditing procedures appropriate to the formulation of an opinion on the fairness of the financial statements.

[Formerly paragraph .64, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .68 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.74 A conceptually logical approach to the auditor's evaluation of accounting control, which focuses directly on the purpose of preventing or detecting material errors and irregularities in financial statements, is to apply the following steps in considering each significant class of transactions and related assets involved in the audit:

- a. Consider the types of errors and irregularities that could occur.
- b. Determine the accounting control procedures that should prevent or detect such errors and irregularities.
- c. Determine whether the necessary procedures are prescribed and are being followed satisfactorily.
- d. Evaluate any weaknesses—i.e., types of potential errors and irregularities not covered by existing control procedures—to determine their effect on (1) the nature, timing, or extent of auditing procedures to be applied and (2) suggestions to be made to the client.

[Formerly paragraph .65, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .69 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.75 In the practical application of the foregoing approach, the first two steps are performed primarily through the development of questionnaires, checklists, instructions, or similar generalized material used by the auditor. However, professional judgment is required in interpreting, adapting, or expanding such generalized material as appropriate in particular situations. The third step is accomplished through the review of the system and tests of compliance and the final step through the exercise of professional judgment in evaluating the information obtained in the preceding steps. [Formerly paragraph .66, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .70 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.76 This suggested approach emphasizes the possibilities for, and controls against, particular types of errors and irregularities concerning particular classes of transactions and related assets. Controls and weaknesses affecting different classes of transactions are not offsetting in their effect. For example, weaknesses in cash receipts procedures are not mitigated by controls in cash disbursement procedures; similarly, weaknesses in billing procedures are not

mitigated by controls in collection procedures. The auditor's review of the system of accounting control and his tests of compliance should be related to the purposes of his evaluation of the system. For this reason, generalized or overall evaluations are not useful for auditors because they do not help the auditor decide the extent to which auditing procedures may be restricted. On the other hand, the auditor ordinarily would confine his evaluation to broad classes of transactions, such as disbursements and sales; he ordinarily would not evaluate separately procedures that result in entries to particular accounts and he usually would not apply his procedures differently within a class of transactions. For example, disbursements may be examined by selecting from all disbursements, without considering the accounts to which the disbursements are charged, and in his examination the auditor would be concerned with validity and approval of supporting documents without regard to the nature of the documentation or the particular individual authorized to approve the disbursement. There may be circumstances, however, in which a more narrow evaluation may be appropriate because control over a class of transactions may be good except as to certain transactions within the class, and it may be more efficient to extend auditing procedures as to only those kinds of transactions. For example, control of cash disbursements may be good except for disbursements for advertising, and it may be more efficient to extend procedures relating to advertising disbursements than to extend procedures relating to all cash disbursements. [Formerly paragraph .67, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .71 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.77 The auditor's evaluation of accounting control with reference to each significant class of transactions and related assets should be a conclusion about whether the prescribed procedures and compliance therewith are satisfactory for his purpose. The procedures and compliance should be considered satisfactory if the auditor's review and tests disclose no condition he believes to be a material weakness for his purpose. In this context, a material weakness is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. These criteria may be broader than those that may be appropriate for evaluating weaknesses in accounting control for management or other purposes. If the auditor is aware of a material weakness in internal accounting control, whether or not he is specifically engaged by the client to review and report on the system of internal accounting control, a communication as described in section 323, *Required Communication of Material Weaknesses in Internal Accounting Control*, is required. [As amended, effective for examinations of financial statements for periods ending on or after December 24, 1977, by Statement on Auditing Standards No. 20.]

(See section 323.) [As amended, July 1980, by Statement on Auditing Standards No. 30.] (See section 642.) [Formerly paragraph .68, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .72 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

Correlation With Other Auditing Procedures

.78 Since the purpose of the evaluation required by the second auditing standard of field work is to provide a basis "for the determination of the resultant extent of the tests to which auditing procedures are to be restricted," it is clear that its ultimate purpose is to contribute to the "reasonable basis for an opinion" comprehended in the third standard of field work, which is as follows:

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.¹⁰

[Formerly paragraph .69, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .73 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.79 The evidential matter required by the third standard is obtained through two general classes of auditing procedures: (a) tests of details of transactions and balances and (b) analytical review procedures applied to financial information. These procedures are referred to in this section as "substantive tests." The purpose of these procedures is to obtain evidence as to the validity and the propriety of accounting treatment of transactions and balances or, conversely, of errors or irregularities therein. Although this purpose differs from that of compliance tests, both purposes often are accomplished concurrently through tests of details. [As amended, October, 1978, by Statement on Auditing Standards No. 23.] (See section 318.) [Formerly paragraph .70, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .74 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.80 The second standard does not contemplate that the auditor will place complete reliance on internal control to the exclusion of other auditing procedures with respect to account balances and classes of transactions where errors could exist that might be material when aggregated with errors in other balances or classes. This interpretation is appropriate for several reasons. First, the connotation of "restricted" in this context does not imply "eliminated." Second, the third standard includes no language suggesting complete reliance on internal control. Finally, the inherent limitations on the

¹⁰ Section 150.02. [Footnote renumbered by issuance of Statement on Auditing Standards No. 48.]

effectiveness of accounting control as discussed in paragraph .35 are the fundamental reasons underlying this interpretation. [Formerly paragraph .71, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .75 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.81 In considering the more difficult question as to the extent of restriction contemplated in the second and third standards, the following excerpts from section 350, *Audit Sampling*, provide a useful conceptual analysis of the intricate relationship between these standards:

.08 ... Audit risk is a combination of the risk that material errors will occur in the accounting process used to develop the financial statements and the risk that any material errors that occur will not be detected by the auditor. The risk of these adverse events occurring jointly can be viewed as the product of the respective individual risks. The auditor may rely on internal accounting control to reduce the first risk and on substantive tests (tests of details of transactions and balances and analytical review procedures) to reduce the second risk.

.19 ... The second standard of field work recognizes that the extent of substantive tests required to obtain sufficient evidential matter under the third standard should vary inversely with the auditor's reliance on internal accounting control. These standards taken together imply that the combination of the auditor's reliance on internal accounting control and his reliance on his substantive tests should provide a reasonable basis for his opinion, although the portion of reliance derived from the respective sources may vary.

[As amended, effective for examinations of financial statements for periods ended on or after June 25, 1982, by SAS No. 39.] (See section 350.) [Formerly paragraph .72, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .76 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.82 The foregoing excerpts recognize not only that the reliance on substantive tests may properly vary inversely with the reliance on internal accounting control, but also that the relative portions of the reliance on substantive tests that are derived from tests of details and from analytical review procedures may properly vary. Regardless of the extent of reliance on internal accounting control, the auditor's reliance on substantive tests may be derived from tests of details, from analytical review procedures, or from any combination of both that he considers appropriate in the circumstances. Variations in this respect may arise from differences in circumstances bearing on the expected effectiveness and efficiency of the respective types of procedures. In this context, effectiveness refers to the audit satisfaction that can be obtained from the procedures, and efficiency refers to the audit time and effort required to perform the procedures. Effectiveness necessarily is the overriding consideration, but efficiency is an appropriate consideration in

choosing between procedures of similar effectiveness. The differences in circumstances having a bearing on expected effectiveness and efficiency may include factors such as the nature of the transactions or balances involved, the availability and stability of experience or other criteria for use in analytical review procedures, the availability of records required for effective tests of details, the volume of such records and the nature of the tests to which they are susceptible, and the timing of the analytical review and/or tests of details in relation to the end of the period being audited. [Formerly paragraph .73, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .77 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

[.83] [Superseded, December 1975, by Statement on Auditing Standards No. 9.] (See section 322.) [Formerly paragraph .74, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .78 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.84 Substantive tests of details may be applied on either a nonstatistical or a statistical basis. Statistical sampling may be a practical means for expressing in quantitative terms the auditor's judgment concerning the reliance to be derived from such tests and for determining sample size and evaluating sample results on that basis. [As modified by the issuance of Statement on Auditing Standards No. 39.] (See section 350.) [Formerly paragraph .75, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, paragraph .79 renumbered by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

AU Section 323

Required Communication of Material Weaknesses in Internal Accounting Control¹

[Superseded by section 325.]

Sources: SAS No. 20; SAS No. 30.

Effective for examinations of financial statements for periods ending on or after December 24, 1977, unless otherwise indicated.

.01 This section requires the auditor to communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control² that come to his attention during an examination of financial statements made in accordance with generally accepted auditing standards.³ * A material weakness in internal accounting control is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. See section 642.31—.34 for factors to be considered in estimating the amounts of errors and irregularities that might result from identified weaknesses in internal accounting control. [As amended, July 1980, by Statement on Auditing Standards No. 30.] (See section 642.)

.02 The existence of material weaknesses in internal accounting control affects the nature, extent, and timing of audit tests to be applied in an examination of financial statements. However, the communication, either orally or in a written report, of such weaknesses of which the auditor is aware is not required to enable the auditor to state that his examination has been

¹ This section amends section 320.77, by the addition of the following sentence:

If the auditor is aware of a material weakness in internal accounting control, whether or not he is specifically engaged by the client to review and report on the system of internal accounting control, a communication as described in section 323, *Required Communication of Material Weaknesses in Internal Accounting Control*, is required. [Reference number 320.72, formerly 320.68, changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference number 320.77, formerly 320.72, changed by the issuance of Statement on Auditing Standards No. 48.]

² [Superseded by Statement on Auditing Standards No. 30. (See section 642.)]

³ [Superseded by Statement on Auditing Standards No. 30. (See section 642.)]

* See also section 722, *Review of Interim Financial Information*, paragraph .10, which states: "If the system of internal accounting control appears to contain weaknesses that do not permit preparation of interim financial information in conformity with generally accepted accounting principles, and, as a consequence, it is impracticable for the accountant to effectively apply his knowledge of financial reporting practices to the interim financial information, he should consider whether the weaknesses represent a restriction on the scope of his engagement sufficient to preclude completion of such a review. . . . The accountant should also advise senior management and the board of directors or its audit committee of the circumstances. . . ." [Reference changed by issuance of Statement on Auditing Standards No. 36.] (See section 722.)

made in accordance with generally accepted auditing standards. Rather, the communication of material weaknesses in internal accounting control is incident to the auditor's objective in making an examination of financial statements, which is to form an opinion as to whether the financial statements present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles consistently applied. Such communication is also incident to the purposes of the auditor's study and evaluation of the system of internal accounting control, which are to establish a basis for reliance thereon and for determination of the resultant extent of the tests to which auditing procedures are to be restricted and to assist him in planning and performing his examination of the financial statements.

.03 The auditor may become aware of material weaknesses in internal accounting control through his initial review of the system. This review is primarily a process of obtaining information about the organization and the procedures prescribed and is intended to serve as a basis for making a preliminary evaluation of the system. If the auditor intends to rely on the prescribed procedures, the review will also serve as a basis for designing related tests of compliance that are intended to provide reasonable assurance that the accounting control procedures are being applied as prescribed. The auditor may also become aware of material weaknesses in internal accounting control by performing such tests of compliance with prescribed procedures. Further, the auditor may become aware of material weaknesses in internal accounting control by performing substantive tests the purpose of which is to obtain evidence as to the validity and propriety of the accounting treatment of transactions and balances or, conversely, of errors or irregularities therein.⁴ However, there is no requirement under generally accepted auditing standards to evaluate each control or to identify every material weakness. Also, the auditor may decide not to test compliance with prescribed procedures relating to all or certain elements of the system because the audit effort required to test compliance exceeds the reduction in audit effort that could be achieved by reliance on the system. The auditor's examination is based on the concept of testing selected items and, thus, is subject to the inherent risk that all material weaknesses in internal accounting control will not be disclosed.

.04 Establishing and maintaining a system of internal accounting control is management's responsibility. Knowledge of material weaknesses in internal accounting control is essential for management to discharge this responsibility by instituting corrective action as necessary in the circumstances. Procedures by which management may obtain knowledge of such weaknesses include, but are not limited to, periodic discussions with other levels of management with respect to weaknesses that come to their attention, reports of internal auditors, and communications from the independent auditor. Consequently, the independent auditor should communicate to senior management and to the board of directors or its audit committee (or the equivalent level of authority, such as a board of trustees) any material weaknesses that come to his attention during the course of his examination of the financial statements if such weaknesses have not been corrected before they come to his attention. Preferably, the auditor's findings should be communicated in a written report to reduce the possibility of misunderstanding. If the auditor's findings are communicated orally, he should document the communication by appropriate notations in his working papers.

⁴ For a discussion of the review of the system of internal accounting control, tests of compliance, and substantive tests, see sections 320.50—.84. [Reference changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

.05 The auditor should communicate material weaknesses in internal accounting control that he becomes aware of through his examination of the financial statements at the earliest practicable date following the completion of his examination. Because of the possible effects of the material weaknesses, the auditor should consider communicating material weaknesses at interim dates after carrying out parts of the examination. When more than one communication is made in connection with an examination, it is not necessary for the auditor to repeat weaknesses reported at interim dates in his final communication, provided he makes reference to the interim communication(s).

.06 If the auditor does not become aware of any material weaknesses in internal accounting control during his examination of the financial statements, he may, but is not required to, communicate that fact.

.07 The auditor's concern for material weaknesses in internal accounting control previously communicated in connection with an examination of prior financial statements is limited to his consideration of such weaknesses and the corrective action taken, if any, as they affect his study and evaluation of internal control in connection with his current examination. If such previously reported weaknesses have not been corrected, the auditor should either repeat them in his communication relating to the current examination, or refer to previous communications.

.08 The form of communication is optional.⁵ When the auditor communicates in writing, the suggested form of report is included in section 642.49—.50. Because it is not practicable to communicate the varying extent of such studies in different engagements, these reports should be prepared for the restricted use of management, the board of directors, or its audit committee.* [As amended, July 1980, by SAS No. 30.] (See section 642.)

.09 If the auditor becomes aware of material weaknesses for which management believes corrective action is not practicable, he may refer to the circumstances and summarize the weaknesses; a detailed communication of the circumstances and related weaknesses is not required. When a written report is issued, the related sentence would state: "However, our study and evaluation disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements may occur and not be detected within a timely period, but management believes corrective action is not practicable in the circumstances." The auditor would then summarize the weaknesses and describe the circumstances (for example, inadequate control over cash transactions because of inadequate segregation of duties due to limited personnel). [As amended, July 1980, by SAS No. 30.] (See section 642.)

.10 The communication of material weaknesses in internal accounting control may include comments concerning corrective action taken or in process. The auditor may also offer suggested corrective action with respect to material weaknesses in internal accounting control for management's consideration. However, any additional study made to develop constructive suggestions is not part of an examination of financial statements made in accordance with generally accepted auditing standards. The auditor may also wish to communicate immaterial weaknesses in internal accounting control but is not required to do so.

.11 Statements on Auditing Standards generally are effective at the time of their issuance. However, since this section provides for practices that may differ in certain respects from practices heretofore considered acceptable, this section will be effective for examinations of financial statements for periods ending on or after December 24, 1977.

➡➡➡ **The next page is 2177.** ⬅⬅⬅

⁵ [Superseded by Statement on Auditing Standards No. 30. (See section 642.)]

* However, when the study and evaluation made as a part of the audit is sufficient for expressing an opinion on the system, see section 642.37—.46.

AU Section 327***The Independent Auditor's
Responsibility for the
Detection of Errors or
Irregularities***

[Superseded by section 316.]

(Supersedes section 110.05—.08)

Source: SAS No. 16.

Issue date, unless otherwise indicated: January, 1977.

.01 This section provides guidance on the independent auditor's responsibility for detecting errors or irregularities when making an examination of financial statements in accordance with generally accepted auditing standards. It also discusses procedures that the auditor should perform when his examination indicates that material errors or irregularities may exist.

.02 The term *errors* refers to unintentional mistakes in financial statements and includes mathematical or clerical mistakes in the underlying records and accounting data from which the financial statements were prepared, mistakes in the application of accounting principles, and oversight or misinterpretation of facts that existed at the time the financial statements were prepared.

.03 The term *irregularities* refers to intentional distortions of financial statements, such as deliberate misrepresentations by management, sometimes referred to as management fraud, or misappropriations of assets, sometimes referred to as defalcations.¹ Irregularities in financial statements may result from the misrepresentation or omission of the effects of events or transactions; manipulation, falsification, or alteration of records or documents; omission of significant information from records or documents; recording of transactions without substance; intentional misapplication of accounting principles; or misappropriation of assets for the benefit of management, employees, or third parties. Such acts may be accompanied by the use of false or misleading records or documents and may involve one or more individuals among management, employees, or third parties.

Relationship of Independent Audits to Other Business Controls

.04 Generally, entities operate with certain controls. Examples of controls for business entities include legal requirements, the monitoring of management activities by boards of directors and their audit committees, the internal audit function, and internal accounting control procedures. Those who rely on

¹ For guidance on other actions that an independent auditor should consider with respect to the possible illegality of such acts, see section 328, *Illegal Acts by Clients*.

financial statements look to entities' controls together with independent audits to provide reasonable assurance that financial statements are not materially misstated as a result of errors or irregularities.

The Auditor's Responsibility

.05 The independent auditor's objective in making an examination of financial statements in accordance with generally accepted auditing standards is to form an opinion on whether the financial statements present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles consistently applied. Consequently, under generally accepted auditing standards the independent auditor has the responsibility, within the inherent limitations of the auditing process (see paragraphs .11—.13), to plan his examination (see paragraphs .06—.10) to search for errors or irregularities that would have a material effect on the financial statements, and to exercise due skill and care in the conduct of that examination. The auditor's search for material errors or irregularities ordinarily is accomplished by the performance of those auditing procedures that in his judgment are appropriate in the circumstances to form an opinion on the financial statements; extended auditing procedures are required if the auditor's examination indicates that material errors or irregularities may exist (see paragraph .14). An independent auditor's standard report implicitly indicates his belief that the financial statements taken as a whole are not materially misstated as a result of errors or irregularities.

The Possibility of Errors or Irregularities

.06 The independent auditor's plan for an examination in accordance with generally accepted auditing standards is influenced by the possibility of material errors or irregularities. The auditor should plan and perform his examination with an attitude of professional skepticism, recognizing that the application of his auditing procedures may produce evidential matter indicating the possibility of errors or irregularities. The scope of the auditor's examination would be affected by his consideration of internal accounting control, by the results of his substantive tests, and by circumstances that raise questions concerning the integrity of management.

Internal Accounting Control and Substantive Tests

.07 Management is responsible for establishing and maintaining internal accounting control procedures including appropriate supervisory review procedures necessary for adherence to adopted policies and prescribed procedures and for identification of errors and irregularities. On the other hand, the auditor evaluates internal accounting control to establish a basis for any reliance thereon in determining the nature, timing, and extent of audit tests to be applied in his examination of the financial statements. Section 320.74—.75 suggests the following approach to the auditor's evaluation of internal accounting control:

A conceptually logical approach to the auditor's evaluation of accounting control, which focuses directly on the purpose of preventing or detecting material errors and irregularities in financial statements, is to apply the following steps in considering each significant class of transactions and related assets involved in the audit:

- a. Consider the types of errors and irregularities that could occur.
- b. Determine the accounting control procedures that should prevent or detect such errors and irregularities.

- c. Determine whether the necessary procedures are prescribed and are being followed satisfactorily.
- d. Evaluate any weaknesses—i. e., types of potential errors and irregularities not covered by existing control procedures—to determine their effect on
 - (1) the nature, timing, or extent of auditing procedures to be applied and
 - (2) suggestions to be made to the client.

In the practical application of the foregoing approach, the first two steps are performed primarily through the development of questionnaires, checklists, instructions, or similar generalized material used by the auditor. However, professional judgment is required in interpreting, adapting, or expanding such generalized material as appropriate in particular situations. The third step is accomplished through the review of the system and tests of compliance and the final step through the exercise of professional judgment in evaluating the information obtained in the preceding steps.

In evaluating internal accounting control, the auditor uses accumulated experience and understanding of the points of risk for possible errors and irregularities. [Reference changed by issuance of Statement on Auditing Standards No. 43. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

.08 Effective internal accounting control reduces the probability that errors or irregularities will occur, but does not eliminate the possibility that they may occur. There are inherent limitations that should be recognized in considering the potential effectiveness of internal accounting control procedures (see section 320.35). Further, whether the objectives of internal accounting control will be achieved depends in substantial part on the competence and integrity of company personnel (see section 320.36). Consequently, the auditor does not place complete reliance on internal accounting control. Section 320.80 states in part:

The second standard [of field work] does not contemplate that the auditor will place complete reliance on internal control to the exclusion of other auditing procedures with respect to material amounts in the financial statements.

Thus, the auditor's examination includes substantive tests (see section 320.79) that are designed to obtain evidential matter concerning the validity and propriety of the accounting treatment of transactions and balances or, conversely, evidential matter indicating the possibility of material errors or irregularities therein even in the absence of material weaknesses² in internal accounting control. Examples of circumstances that may lead the auditor to question whether material errors or possible irregularities exist include the following: (a) discrepancies within the accounting records, such as a difference between a control account and its supporting subsidiary records; (b) differences disclosed by confirmations; (c) significantly fewer responses to confirmation requests than expected; (d) transactions not supported by proper

² Section 320.77 defines a material weakness as follows:

... a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

[As amended, July 1980, by Statement on Auditing Standards No. 30.] (See section 642.) [Reference number 320.72, formerly 320.68, changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference number 320.77, formerly 320.72, changed by the issuance of Statement on Auditing Standards No. 48.]

documentation; (e) transactions not recorded in accordance with management's general or specific authorization; and (f) the completion of unusual transactions at or near year end. However, the existence of any of those circumstances does not necessarily mean that material errors or irregularities do exist. [Reference numbers 320.74—.75, formerly 320.70—.71, changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, references changed by the issuance of Statement on Auditing Standards No. 48.]

Integrity of Management

.09 The auditor should recognize that management can direct subordinates to record or conceal transactions in a manner that could result in a material misstatement of the financial statements. Thus, management can perpetrate irregularities by overriding controls that would prevent similar irregularities by other employees. Consequently, the auditor should be aware of the importance of management's integrity to the effective operation of internal accounting control procedures and should consider whether there are circumstances that might predispose management to misstate financial statements. Such circumstances might include those of a company that is in an industry experiencing a large number of business failures, or that lacks sufficient working capital or credit to continue operations.

.10 The auditor should consider the possibility that management may have made material misrepresentations or may have overridden control procedures. The auditor's consideration should include factors such as the nature of the entity being audited, the susceptibility to irregularities of the item or transaction being examined, the degree of authority vested at various management levels, and prior experience with the entity. For example, the following circumstances, although not necessarily indicative of the presence of irregularities, may cause the auditor to be concerned about the possibility that management may have made material misrepresentations or overridden internal control procedures: (a) the company does not correct material weaknesses in internal accounting control that are practicable to correct; (b) key financial positions, such as controller, have a high turnover rate; or (c) the accounting and financial functions appear to be understaffed, resulting in a constant crisis condition and related loss of controls. However, unless the auditor's examination reveals evidential matter to the contrary, it is reasonable for him to assume that management has not made material misrepresentations or has not overridden control procedures.

Inherent Limitations of an Audit

.11 An examination made in accordance with generally accepted auditing standards is subject to the inherent limitations of the auditing process. As with certain business controls, the costs of audits should bear a reasonable relationship to the benefits expected to be derived. As a result, the concept of selective testing of the data being examined, which involves judgment both as to the number of transactions to be examined and as to the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Thus, the auditor's examination, based on the concept of selective testing of the data being examined, is subject to the inherent risk that material errors or irregularities, if they exist, will not be detected.

.12 The risk that material errors or irregularities will not be detected is increased by the possibility of management's override of internal controls, collusion, forgery, or unrecorded transactions. Certain acts, such as collusion between client personnel and third parties or among management or employees of the client, may result in misrepresentations being made to the auditor or in the presentation to the auditor of falsified records or documents that appear truthful and genuine. Unless the auditor's examination reveals evidential matter to the contrary, his reliance on the truthfulness of certain representations and on the genuineness of records and documents obtained during his examination is reasonable. Examples of representations that are normally accepted by the auditor are (a) those of management concerning its intent or knowledge and the completeness of the entity's records and (b) those of third parties, such as confirmations of accounts receivable by debtors and accounts payable by creditors, and confirmations and other documents received from banks or other depositories. Further, the auditor cannot be expected to extend his auditing procedures to seek to detect unrecorded transactions unless evidential matter obtained during his examination indicates that they may exist. For example, an auditor ordinarily would not extend his auditing procedures to seek failures to record the receipt of cash from unexpected sources.

.13 In view of those and other limitations on the effectiveness of auditing procedures, the subsequent discovery that errors or irregularities existed during the period covered by the independent auditor's examination does not, in itself, indicate inadequate performance on his part. The auditor is not an insurer or guarantor; if his examination was made in accordance with generally accepted auditing standards, he has fulfilled his professional responsibility.

Procedures When the Examination Indicates That Errors or Irregularities May Exist

.14 If the independent auditor's examination causes him to believe that material errors or irregularities may exist, he should consider their implications and discuss the matter and the extent of any further investigation with an appropriate level of management that is at least one level above those involved. If after such discussions the auditor continues to believe that material errors or irregularities may exist, he should determine that the board of directors or its audit committee is aware of the circumstances. Also, he should attempt to obtain sufficient evidential matter to determine whether in fact material errors or irregularities exist and, if so, their effect. In this regard, the auditor may wish to consult with the client's legal counsel on matters concerning questions of law. If practicable, the auditor should extend his auditing procedures in an effort to obtain such evidential matter. In some circumstances, however, it may be impracticable or impossible to obtain sufficient evidential matter to determine the existence, or related effect, of material errors or possible irregularities, or management may impose a limitation on the scope of the auditor's search for the evidential matter needed to reach a conclusion.³ When the auditor's examination indicates the presence of errors or possible irregularities, and the auditor remains uncertain about whether these errors or possible irregularities may materially affect the financial statements, he should qualify his opinion or disclaim an opinion on the financial statements and, depending on the circumstances, consider with-

³ For a discussion of the effect of a restriction on the scope of an auditor's examination whether imposed by the client or by circumstances, see section 509.10—.13, *Reports on Audited Financial Statements*.

drawing from the engagement, indicating his reasons and findings in writing to the board of directors. In such circumstances, the auditor may wish to consult with his legal counsel.

.15 The independent auditor's examination may reveal errors or possible irregularities that he concludes could not be so significant as to materially affect the financial statements he is examining. For example, irregularities involving peculations from a small imprest fund would normally be of little significance because both the manner of operating the fund and its size would tend to establish a limitation on the amount of a loss. The auditor should refer such matters to an appropriate level of management that is at least one level above those involved, with the recommendation that the matter be pursued to a conclusion. Also, the auditor should consider the effect of any immaterial irregularity as it may relate to other aspects of his examination, such as the role of the personnel involved in the system of internal accounting control.

AU Section 328

Illegal Acts by Clients

[Superseded by section 317.]

Source: SAS No. 17.

See section 9317 for interpretations of this section.

Issue date, unless otherwise indicated: January, 1977.

.01 This section provides guidance for an auditor when client acts that appear to him to be illegal come to his attention during an examination of financial statements in accordance with generally accepted auditing standards. This section also discusses the extent of the attention he should give, when performing such an examination, to the possibility that such acts may have occurred. The types of acts encompassed by this section include illegal political contributions, bribes, and other violations of laws and regulations.

.02 This section sets forth guidelines for the appropriate conduct of an auditor in fulfilling his obligation to report on financial statements in accordance with professional standards when he becomes aware of an illegal act (paragraphs .04—.17). It also offers practical suggestions for an auditor in connection with illegal acts not having a material effect on the financial statements (paragraph .18) and sets forth considerations applicable to notification of other parties of an illegal act (paragraph .19).

.03 An examination made in accordance with generally accepted auditing standards cannot be expected to provide assurance that illegal acts will be detected.¹ In reporting on financial statements, an auditor holds himself out as one who is proficient in accounting and auditing. The determination of whether an act is illegal is usually beyond his professional competence. The auditor's training and experience, however, ordinarily should provide a reasonable basis for an awareness that some client acts coming to an auditor's attention in the performance of his examination might be illegal. Nevertheless, the further removed an illegal act is from the events and transactions specifically reflected in financial statements, the less likely the auditor is to become aware of the act or recognize its possible illegality. For example, violations of the Occupational Safety and Health Act are not ordinarily specifically reflected in financial statements, and the auditor ordinarily does not have a sufficient basis for the awareness needed to recognize the possible illegality of such violations.

Procedures That May Identify Illegal Acts

.04 In making an examination in accordance with generally accepted auditing standards, an auditor should be aware of the possibility that illegal acts may have occurred that may have a material effect on the financial statements. Procedures that are performed primarily for the purpose of expressing an opinion on the financial statements that may also bring possible illegal acts to the auditor's attention include tests of transactions and balances and the study and evaluation of internal accounting control (paragraphs .05—

¹ See section 327, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*, regarding the limitations of an examination in accordance with generally accepted auditing standards.

.07), and inquiries of management and others (paragraphs .08 and .09). If as a result of those procedures the auditor believes that illegal acts may have occurred, he should inquire of the client's management and consult with the client's legal counsel or other specialists, as necessary, to obtain an understanding of the nature of the acts and their possible effects on the financial statements. The auditor may also perform additional procedures to investigate such matters.

.05 The auditor's tests of transactions and balances, his study and evaluation of internal accounting control, and his tests of compliance, if any, with such controls may bring to his attention unauthorized transactions, transactions improperly recorded, or transactions not recorded in a complete or timely manner to maintain accountability for assets. Such transactions may raise questions about the possible existence of an illegal act. The auditor's interest in internal accounting control relates to the authorization, execution, and recording of transactions and accountability for the related assets (see sections 320.26—.41 and 320.44—.49). [References changed by the issuance of Statement on Auditing Standards No. 48.]

.06 In conducting his examination, the auditor obtains evidential matter as to the propriety of the accounting treatment of and support for transactions and balances. The procedures performed to obtain such evidential matter include obtaining an understanding of the transactions tested and their business purpose. A transaction that appears to the auditor to have an unusual or questionable purpose may raise questions about the possible existence of an illegal act.

.07 As part of his examination, the auditor considers laws and regulations that have a direct effect on the amounts presented in financial statements. For example, tax laws affect accruals and the amount recognized as an expense in the accounting period. Also, applicable laws or regulations may affect the amount of revenue accrued under government contracts.

.08 The auditor's examination should include inquiries of the client's management in connection with the accounting for and disclosure of loss contingencies and related communication with the client's legal counsel. The auditor should also inquire about the client's compliance with laws and regulations, the client's policies relevant to the prevention of illegal acts, and internal communications, such as directives issued by the client and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations. Possible illegal acts may come to the auditor's attention through such inquiries. For example, an auditor may learn of an investigation by a governmental agency or enforcement proceedings concerning violations of laws with respect to occupational safety and health, food and drug administration, truth in lending, environmental protection, price fixing or other anti-trust practices, or violations of laws and regulations of foreign countries.

.09 The laws and regulations governing matters such as those indicated in paragraph .08 are highly specialized and complex. Also, they often relate to the operating aspects of an entity rather than its financial or accounting aspects. Therefore, the auditor's examination cannot reasonably be expected to bring to his attention violations of those types of laws and regulations, unless he becomes aware of external evidence, such as a governmental agency investigation or an enforcement proceeding, or obtains information from the client's management or legal counsel drawing his attention to such matters.

Evaluation of the Materiality of an Illegal Act

.10 In evaluating the materiality of an illegal act that comes to his attention, the auditor should consider the effects, if any, on the amounts presented in the financial statements, including related contingent monetary effects of the violation. Contingent monetary effects include fines, penalties, and damages. Loss contingencies required to be disclosed should also be considered.

.11 Loss contingencies, such as the threat of expropriation of assets, enforced discontinuance of operations in a foreign country, or possible litigation, may arise as a result of an illegal act. The auditor's considerations for evaluating the materiality of those loss contingencies are similar to those applicable to other loss contingencies.²

.12 The auditor should also evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the operations of the entity. If a material amount of revenue or earnings is derived from transactions involving illegal acts, or if illegal acts create significant unusual risks associated with a material amount of revenue or earnings, such as the loss of a significant business relationship, that information ordinarily should be considered for disclosure in the financial statements.

.13 After it has been determined that an illegal act has occurred, the auditor should report the circumstances to personnel within the client's organization at a high enough level of authority so that appropriate action can be taken by the client with respect to—

- a. consideration of remedial actions;
- b. adjustments or disclosures that may be necessary in the financial statements;
- c. disclosures that may be required in other documents (such as a proxy statement).

In some circumstances, the only persons in the organization of a sufficiently high level of authority to take necessary action may be the audit committee or the board of directors. The auditor should also consider the implications of an illegal act in relation to the intended degree of reliance to be placed on internal accounting control and the representations of management.

² Generally accepted accounting principles for the financial accounting for and reporting of loss contingencies are contained in Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* [AC section C59].

Effects on the Auditor's Report

.14 The auditor may not be able to determine the amounts associated with certain events, taken alone or with similar events, of which he becomes aware, or whether an act is, in fact, illegal, because of an inability to obtain sufficient competent evidential matter. For example, the act may have been accomplished by circumventing the internal control system and may not be properly recorded or otherwise adequately documented, or the client's legal counsel may refuse to advise on the illegality of a material act. In those circumstances, the auditor should consider the need to qualify his opinion or disclaim an opinion because of the scope limitation (see section 509.10-.12).

.15 If the auditor concludes that the effect of an event, taken alone or with similar events, is material in amount and that the event has not been properly accounted for or disclosed in the financial statements, he should qualify his opinion or express an adverse opinion because of the departure from generally accepted accounting principles (see section 509.15-.17).

.16 The auditor may conclude that an illegal act's effects on the financial statements are not susceptible of reasonable estimation. When such an uncertainty exists,³ the auditor should consider the need to modify his report (see section 509.21-.25).

.17 If the client informs the auditor that it will refuse to accept an auditor's report that has been modified for the reasons cited in paragraphs .14-.16, the auditor should withdraw from the current engagement, indicating the reasons for his withdrawal in writing to the board of directors. In such circumstances, the auditor may wish to consult with his legal counsel.

Other Considerations Regarding Illegal Acts

.18 When an illegal act, including one that does not have a material effect on the financial statements, comes to the auditor's attention, he should consider the nature of the act and management's consideration once the matter is brought to their attention. If the client's board of directors, its audit committee, or other appropriate levels within the organization do not give appropriate consideration (see paragraph .13) to the illegal act, the auditor should consider withdrawing from the current engagement or dissociating himself from any future relationship with the client. The auditor's decision as to whether to withdraw or dissociate because of an illegal act, including one not having a material effect on the financial statements, is ordinarily affected by (a) the effects on his ability to rely on management's representations and (b) the possible effects of continuing his association with the client. In reaching a decision on withdrawal or dissociation, the auditor may wish to consult with his legal counsel.

³ For example, such an uncertainty may exist when it is reasonably possible, or probable, that a loss contingency arising from an illegal act will be resolved by a future event and the amount of the potential loss cannot be estimated. See Statement of Financial Accounting Standards No. 5, paragraphs 8-10 [AC section C59.105-.111].

.19 Deciding whether there is a need to notify parties other than personnel within the client's organization of an illegal act is the responsibility of management. Generally, the auditor is under no obligation to notify those parties. However, if the auditor considers the illegal act to be sufficiently serious to warrant withdrawing from the engagement, he should consult with his legal counsel as to what other action, if any, he should take.

➤ *The next page is 2189.* ➤

AU Section 340***The Auditor's Considerations
When a Question Arises
About an Entity's
Continued Existence***

[Superseded by section 341.]

Source: SAS No. 34.

Issue date, unless otherwise indicated: March, 1981.

.01 When the continued existence of an entity is imperiled, there is heightened concern about the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities. This section provides guidance regarding the auditor's considerations when information comes to his attention that raises a question about an entity's ability to continue in existence.¹

.02 Ordinarily, such a question relates to the entity's ability to continue to meet its obligations as they become due without substantial disposal of assets, restructuring of debt, externally forced revisions of its operations, or similar actions. Other factors, not presently involving solvency, may also bring into question an entity's ability to continue in existence (for example, loss of key personnel, principal customer, essential supply source, or primary revenue producing assets).

.03 In an examination of financial statements in accordance with generally accepted auditing standards, the auditor does not search for evidential matter relating to the entity's continued existence because, in the absence of information to the contrary, an entity's continuation is usually assumed in financial accounting.² Nevertheless, the auditor remains aware that auditing procedures applied primarily for other purposes may bring to his attention information contrary to that assumption. In forming an opinion on the financial statements, the auditor considers any such contrary information, together with any factors tending to mitigate that information and any management plans for dealing with the underlying conditions.

Contrary Information

.04 In this context contrary information includes information that comes to the auditor's attention, at any time through the date of his report, relating to an entity's ability, at the date of the financial statements, to continue in existence. The following examples of contrary information vary widely in

¹ This section does not apply to an examination of financial statements based on the assumption of liquidation (for example, when (a) an entity is in the process of dissolution or liquidation, (b) the owners have determined to commence dissolution or liquidation, or (c) legal proceedings, including bankruptcy, have reached a point at which dissolution or liquidation is probable).

² See Accounting Principles Board Statement No. 4, paragraph 25.

importance, and some may have significance only when viewed in conjunction with others.

- a. Information that may indicate solvency problems:
 - Negative trends (for example, recurring operating losses, working capital deficiencies, negative cash flows from operations, and adverse key financial ratios).
 - Other indications (for example, default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, noncompliance with statutory capital requirements, and necessity of seeking new sources or methods of financing).
- b. Information that may raise a question about continued existence without necessarily indicating potential solvency problems:
 - Internal matters (for example, loss of key management or operations personnel, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, and uneconomic long-term commitments).
 - External matters (for example, legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; and uninsured catastrophes such as drought, earthquake, or flood).

Mitigating Factors

.05 Factors tending to mitigate the significance of contrary information concerning solvency relate primarily to an entity's alternative means for maintaining adequate cash flows. Examples of such factors include the following.

- a. Asset factors:
 - Disposability of assets not operationally interdependent.
 - Capability of delaying the replacement of assets consumed in operations or of leasing rather than purchasing certain assets.
 - Possibility of using assets for factoring, sale-leaseback, or similar arrangements.
- b. Debt factors:
 - Availability of unused lines of credit or similar borrowing capacity.
 - Capability of renewing or extending the due dates of existing loans.
 - Possibility of entering into debt restructuring agreements.
- c. Cost factors:
 - Separability of operations producing negative cash flows.
 - Capability of postponing expenditures for such matters as maintenance or research and development.
 - Possibility of reducing overhead and administrative expenditures.
- d. Equity factors:
 - Variability of dividend requirements.

- Capability of obtaining additional equity capital.
- Possibility of increasing cash distributions from affiliates or other investees.

.06 Factors tending to mitigate the significance of contrary information not necessarily concerning solvency relate primarily to the entity's capacity to adopt alternative courses of action (for example, the availability of qualified persons to fill a vacated key position, the likelihood of suitably substituting for a lost principal customer or supplier, the possibility of adequately replacing assets seized or destroyed, and the capability of operating at reduced levels or of redeploying resources).

Consideration of Contrary Information and Mitigating Factors

.07 The auditor's initial consideration of contrary information focuses on the underlying conditions that resulted in the contrary information (for example, whether the conditions are indicative of a rapid or a gradual deterioration, whether they are temporary or recurring, whether they are susceptible of corrective actions solely within the entity, and whether they are applicable to identifiable elements or segments of the entity or are pervasive). The auditor's initial consideration of mitigating factors is based primarily on (a) knowledge of matters that relate to the nature of the entity's business and its operating characteristics and of matters affecting the industry in which it operates, including an awareness of the specific effects and general influence of international, national, and local economic conditions, (b) discussions with principal officers having responsibility for administration, finance, operations, and accounting activities, and (c) understanding of possible legal implications, if any, based on discussions with appropriate legal counsel when that is deemed necessary.

Consideration of Management Plans

.08 Additional considerations often are necessary; they generally focus on management plans that are responsive to the observed conditions that resulted in the contrary information. The relevance of such plans to an auditor generally decreases as the time period for planned actions and anticipated events increases, although longer time periods may be more meaningful in industries with a lengthy operating cycle. Particular emphasis ordinarily is placed on plans that might have a significant effect on the entity's solvency within a period of one year following the date of the financial statements on which the auditor is currently reporting. The auditor's considerations relating to such management plans may include the following.

- a. Plans to liquidate assets:
 - Apparent marketability of the assets that management plans to sell.
 - Restrictions on the disposal of assets, such as covenants limiting such transactions in loan or similar agreements or encumbrances against assets.
 - Possible direct and indirect effects of the disposal of assets.
- b. Plans to borrow money or restructure debt:
 - Availability of debt financing, including existing or committed credit arrangements, such as lines of credit and arrangements for factoring receivables or sale-leaseback of assets.

- Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity.
 - Possible effects on management's borrowing plans of existing restrictions on additional borrowing and the sufficiency of available collateral.
- c. Plans to reduce or delay expenditures:
- Apparent feasibility of plans to reduce overhead and administrative expenditures, to postpone maintenance or research and development projects, or to lease rather than purchase assets.
 - Possible direct and indirect effects of reduced or delayed expenditures.
- d. Plans to increase ownership equity:
- Apparent feasibility of plans to increase ownership equity, including existing or committed arrangements to raise additional capital.
 - Existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investees.

.09 The auditor also should discuss with management any forecasts, projections, budgets, or other prospective data, particularly data relating to cash flows, that are available or that can reasonably be developed and that are relevant in relation to the plans discussed in paragraph .08. The auditor should consider the support for significant assumptions underlying the prospective data and should give particular attention to assumptions that are

- Material to the relevant forecasts or projections.
- Especially uncertain or sensitive to variations.
- In deviation from historical trends.

The auditor's considerations should be based on (a) reading of the prospective data and the underlying assumptions, (b) knowledge of the entity, its business, and its management, and (c) comparison of prospective data in prior periods with historical results and of prospective data for the current forecast period with results achieved to date. If the auditor becomes aware of relevant factors the effects of which are not reflected in such prospective data, he should also take those factors into account. The auditor's function, however, does not include predicting the outcome of future events, and an unqualified opinion on the financial statements does not constitute a guarantee or assurance by the auditor that the entity has the ability to continue for any particular period beyond the date of his opinion.

Consideration of Informative Disclosures

.10 The auditor should consider the need for, and the adequacy of, disclosure of the principal conditions that raise a question about an entity's ability to continue in existence, the possible effects of such conditions, and management's evaluation of the significance of those conditions and any mitigating factors. If disclosure is necessary and a satisfactory resolution of the question depends primarily on the realization of particular plans of management, the disclosure should deal with that fact and such plans.

Consideration of the Effects on the Auditor's Report

.11 After (a) considering the significance of the contrary information and any mitigating factors, (b) discussing plans, prospective data, and other appropriate matters with management, and (c) making any substantive tests that the auditor considers necessary and practicable to assess such information, factors, and plans, the auditor may conclude that the question raised about the entity's ability to continue in existence should not result in a modification of his report. On the other hand, the auditor may conclude that a substantial doubt remains about the entity's ability to continue in existence. In such a case, he should consider the recoverability and classification of recorded asset amounts, and the amounts and classification of liabilities, in light of that doubt. Identifying the point at which uncertainties about recoverability, classifications, and amounts require the auditor to modify his report is a complex professional judgment. No single factor or combination of factors is controlling. Reporting guidance is provided in section 509, *Reports on Audited Financial Statements*, particularly in "Inadequate Disclosure" (section 509.17) and in "Uncertainties" (section 509.21—26).

.12 An example follows of a report qualified for an uncertainty about the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities because of a substantial doubt about an entity's ability to continue in existence.

(Explanatory paragraph)

As shown in the financial statements, the company incurred a net loss of \$..... during the year ended December 31, 19XX, and, as of that date, the company's current liabilities exceeded its current assets by \$..... and its total liabilities exceeded its total assets by \$..... These factors, among others, as discussed in Note X, indicate that the company may be unable to continue in existence. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the company be unable to continue in existence.

(Opinion paragraph)

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty about the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities referred to in the preceding paragraph been known, the financial statements referred to above present fairly the financial position of X Company as of December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.13 When financial statements of one or more prior periods are presented on a comparative basis with financial statements of the current period, reporting guidance is provided in section 505, *Reports on Comparative Financial Statements*.³ If a substantial doubt about the entity's ability to continue in existence becomes apparent in the current period, it would not imply that a basis for such doubt also existed in the prior period. Accordingly, an uncertainty concerning the recoverability and classification of recorded asset

³ Section 505.06 is amended to add the following footnote to the second item. See section 340.13 for guidance concerning the auditor's discovery of an uncertainty about an entity's ability to continue in existence.

amounts, or the amounts and classification of liabilities, in the financial statements of the current period because of a substantial doubt about an entity's ability to continue in existence will not ordinarily affect the financial statements of the prior period that are presented on a comparative basis. Furthermore, modification of the auditor's report on the current period's financial statements normally would adequately communicate the nature and significance of the uncertainty. Thus, the auditor ordinarily should modify his report on only the current period's financial statements because of an uncertainty due to a substantial doubt that arose in the current period about the entity's ability to continue in existence.

AU Section 505

Reports on Comparative Financial Statements

[Superseded by section 508.]

(Supersedes sections 315.11, 509.49 and 516.11—.12)¹

Sources: SAS No. 15; SAS No. 34; SAS No. 43.

See section 9508 for interpretations of this section.

Effective for reports issued on comparative financial statements for periods ending after June 30, 1977, unless otherwise indicated.

.01 This section provides guidance to an auditor reporting on financial statements of one or more prior periods that are presented on a comparative basis with financial statements of the current period.²

Auditor's Standard Report on Comparative Financial Statements

.02 The fourth standard of reporting requires that an auditor's report contain either an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. Reference in the fourth reporting standard to the financial statements "taken as a whole" should now be considered to apply not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor³ should update⁴ his report on the individual financial statements of the one or more prior periods presented on a

¹ This section also supersedes the auditing interpretation of section 509.49 on "Reporting on Comparative Financial Statements of Nonprofit Organizations," January 1976 (AU section 9509.07—.10).

² See section 543.16—.17, for reporting on restated financial statements of prior years following a pooling of interests.

³ A continuing auditor is one who has examined the financial statements of the current period and of one or more consecutive periods immediately prior to the current period.

If one firm of independent auditors merges with another firm and the new firm becomes the auditor of a former client of one of the former firms, the new firm may accept responsibility and express an opinion on the financial statements for the prior period(s) as well as those for the current period. In such circumstances, the new firm should follow the guidance in paragraphs .03—.07 and may indicate in its report or signature that a merger took place, and may name the firm of independent auditors that was merged with it. If the new firm decides not to express an opinion on the prior-period financial statements, the guidance in paragraphs .08—.12 should be followed.

⁴ The term "update" means to re-express a previous opinion or, depending on the circumstances, to express a different opinion from that previously expressed on the financial statements of a prior period. An updated report on prior-period financial statements should be distinguished from a reissuance of a previous report (see section 530.06—.08) since in issuing an updated report the continuing auditor considers information that he has become aware of during his examination of the current-period financial statements (see paragraph .04) and because an updated report is issued in conjunction with the auditor's report on the current-period financial statements.

comparative basis with those of the current period.⁵ Ordinarily, the auditor's report on comparative financial statements should be dated as of the date of completion of his most recent examination (see section 530.01).

.03 An example of a continuing auditor's standard report on comparative financial statements for two fiscal periods is as follows:

We have examined the balance sheets of ABC Company as of [at] December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of ABC Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

If statements of income, retained earnings, and changes in financial position are presented on a comparative basis for one or more prior periods, but the balance sheet(s) as of the end of such period(s) is not presented, the phrase "for the years then ended" should be changed to indicate that the auditor's opinion applies to each period for which statements of income, retained earnings, and changes in financial position are presented, such as "for each of the five years in the period ended [date of latest balance sheet]."

.04 During his current examination, the auditor should be alert for circumstances or events that affect the prior-period financial statements presented (see paragraph .06) or the adequacy of informative disclosures

⁵ A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, nonprofit organizations such as hospitals, colleges and universities, voluntary health and welfare organizations, and state and local government units frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats.

In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, that will necessitate including additional columns or separate detail by fund, or the auditor would need to modify his report.

concerning those statements (see section 431, and ARB No. 43, Chapter 2A [AC section F43]). The auditor should consider the effects of any such circumstances or events coming to his attention in updating his report on the prior-period financial statements. [Reference number 431, formerly 430, changed by issuance of Statement on Auditing Standards No. 32.]

Report With Differing Opinions

.05 Since the auditor's report on comparative financial statements applies to the individual financial statements presented, an auditor may modify⁶ his opinion or disclaim an opinion with respect to one or more financial statements for one or more periods, while expressing an unqualified opinion on the other financial statements presented. When this situation occurs, the auditor should disclose all the substantive reasons for modifying or disclaiming an opinion in a separate explanatory paragraph(s) of his report and should include in the opinion paragraph an appropriate modification or disclaimer of opinion and a reference to the explanatory paragraph(s). An explanatory paragraph is not required, however, when the opinion paragraph has been modified because of a change in accounting principle. (See section 509.02 through 509.47.) Following are examples of reports on comparative financial statements (excluding the standard scope paragraph, where applicable) with different opinions or a disclaimer of opinion on one or more financial statements presented.

Qualified Opinion on Current Year's Financial Statements With Prior Year Unqualified

(Explanatory paragraph)

As discussed in Note X, during 19X2 the Company became a defendant in a lawsuit relating to the sale in 19X2 of a wholly owned subsidiary. The ultimate outcome of the lawsuit cannot be determined, and no provision for any liability that may result has been made in the 19X2 financial statements.

(Opinion paragraph)⁷

In our opinion, subject to the effect on the 19X2 financial statements of such adjustments, if any, as might have been required had the outcome of the

⁶ The term "modify" covers reporting situations that would result in the expression of a qualified opinion or an adverse opinion.

⁷ In those rare instances when resolution of an uncertainty will be accounted for as a prior period adjustment, the auditor's reservations may be expressed in the following manner: "In our opinion, subject to the effects, if any, on the financial statements of the ultimate resolution of the matter discussed in the preceding paragraph, the financial statements referred to above present fairly. . . ." [As amended, effective after August 31, 1982 by Statement on Auditing Standards No. 43.]

uncertainty referred to in the preceding paragraph been known, the financial statements referred to above present fairly the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Qualified Opinion on Prior Year's Financial Statements With the Current Year Qualified for the Same Reason and an Additional Reason

(Explanatory paragraphs)

The Company has excluded from property and debt in the accompanying 19X2 balance sheet certain lease obligations that were entered into in 19X2, which, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$....., long-term debt by \$....., and retained earnings by \$..... as of December 31, 19X2, and net income and earnings per share would be increased (decreased) by \$..... and \$....., respectively, for the year then ended.

As discussed in Note X, the Company is involved in continuing litigation relating to patent infringement. The ultimate outcome of this litigation cannot be determined, and no provision for any liability that may result has been made in the 19X2 or 19X1 financial statements.

(Opinion paragraph)

In our opinion, except for the effects on the 19X2 financial statements of not capitalizing certain lease obligations, as described in the second paragraph, and subject to the effects on the 19X2 and 19X1 financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the financial statements referred to above present fairly the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Unqualified Opinion on the Current Year's Financial Statements With Disclaimer of Opinion on the Prior Year's Statements of Income, Retained Earnings, and Changes in Financial Position

(Scope paragraph)

... Except as explained in the following paragraph, our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

(Explanatory paragraph)

We did not observe the taking of the physical inventory as of December 31, 19X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures.

(Opinion paragraph)

In our opinion, the balance sheets of ABC Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and changes in financial position for the year ended December 31, 19X2, present fairly the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and the changes in its financial position for the year ended December 31, 19X2, in conformity with generally accepted accounting principles applied on a consistent basis.⁸

(Disclaimer paragraph)

Because of the matter discussed in the second paragraph, the scope of our work regarding inventories as of December 31, 19X0, was not sufficient to enable us to express, and we do not express, an opinion on the statements of income, retained earnings, and changes in financial position for the year ended December 31, 19X1.

Report With an Updated Opinion Different From a Previous Opinion

.06 If during his current examination an auditor becomes aware of circumstances or events that affect the financial statements of a prior period, he should consider such matters when updating his report on the financial statements of the prior period. The following circumstances or events ordinarily should cause an auditor to express an opinion different from that expressed in an earlier report on the financial statements of the prior period:

- *Subsequent resolution of an uncertainty.* The resolution in the current period of an uncertainty that caused an auditor to modify his opinion or disclaim an opinion on the financial statements of a prior period eliminates the need for the modification or disclaimer of opinion in the auditor's updated report. Accordingly, the auditor's updated report on

⁸ It is assumed that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles (see sections 420 and 546.14—.16).

the financial statements of the prior period should recognize the subsequent resolution of the uncertainty and should no longer be qualified with respect to the resolved uncertainty.

- *Discovery of an uncertainty in a subsequent period.* If, during his current examination, an auditor becomes aware of an uncertainty that affects the prior-period financial statements presented, he should modify his opinion or disclaim an opinion in his updated report on those statements because of the uncertainty.*
- *Subsequent restatement of prior-period financial statements.* If an auditor has previously modified his opinion on financial statements of a prior period because of a departure from generally accepted accounting principles, and the prior-period financial statements are restated in the current period to conform with generally accepted accounting principles, the auditor's updated report on the financial statements of the prior period should indicate that the statements have been restated and should express an unqualified opinion with respect to the restated financial statements.

.07 If, in an updated report, an auditor expresses an opinion (or disclaims an opinion) different from his previous opinion (or disclaimer of opinion) on the financial statements of a prior period, he should disclose all the substantive reasons for the different opinion in a separate explanatory paragraph(s) of his report.⁹ Also, if the updated opinion is other than unqualified, the auditor should include in the opinion paragraph (or disclaimer paragraph) an appropriate modification and a reference to the explanatory paragraph(s) in the report. The explanatory paragraph(s) should disclose (a) the date of the auditor's previous report, (b) the type of opinion previously expressed, (c) the circumstances or events that caused the auditor to express a different opinion, and (d) that the auditor's updated opinion on the financial statements of the prior period is different from his previous opinion on those statements. The following are examples of explanatory paragraphs appropriate when an auditor expresses an opinion different from that expressed in a previously issued report on the financial statements of a prior period.

* See section 340.13 for guidance concerning the auditor's discovery of an uncertainty about an entity's ability to continue in existence. [As amended March, 1981, by Statement on Auditing Standards No. 34.]

⁹ A separate explanatory paragraph is required only when the current updated opinion is different from the last opinion issued. For example, a separate explanatory paragraph is not required in an auditor's report that appears in a registration statement filed under the Securities Act of 1933 if the explanatory paragraph was previously included in the auditor's report on a registrant's financial statements included in its annual report filed with regulatory authorities under the Securities Exchange Act of 1934.

Resolution in the Current Period of an Uncertainty Existing in a Prior Period Requiring No Adjustment of the Financial Statements

In our report dated March 1, 19X2, our opinion on the 19X1 financial statements was qualified as being subject to the effects on the 19X1 financial statements of such adjustments, if any, as might have been required had the outcome of certain litigation been known. As explained in Note X, the litigation was settled as of November 1, 19X2, at no material cost to the Company. Accordingly, our present opinion on the 19X1 financial statements, as presented herein, is different from that expressed in our previous report.

Resolution in the Current Period of an Uncertainty Existing in a Prior Period Requiring Recognition in the Current Financial Statements

In our report dated March 1, 19X2, our opinion on the 19X1 financial statements was qualified as being subject to the realization of the investment in DEF Company. As explained in Note X, the carrying amount of that investment has been charged to operations in the current year as required by generally accepted accounting principles. Accordingly, our present opinion on the 19X1 financial statements, as presented herein, is different from that expressed in our previous report.

A New Uncertainty Affecting Both the Current- and Prior-Period Financial Statements

As discussed in Note X, a number of legal actions were filed against the Company subsequent to the date of our report on the 19X1 financial statements. These actions claim substantial damages as a result of alleged violations of antitrust laws during prior years. The Company is in the process of litigating these actions, but the ultimate outcome is uncertain at this time. In our report dated March 1, 19X2, our opinion on the 19X1 financial statements was unqualified; however, in view of the litigation referred to above, our present opinion on the 19X1 financial statements, as presented herein, is different from that expressed in our previous report.

Subsequent Restatement of Prior-Period Financial Statements to Conform With Generally Accepted Accounting Principles

In our report dated March 1, 19X2, we expressed an opinion that the 19X1 financial statements did not fairly present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has restated its 19X1 financial

statements to conform with generally accepted accounting principles. Accordingly, our present opinion on the 19X1 financial statements, as presented herein, is different from that expressed in our previous report.

Report of Predecessor Auditor

.08 A predecessor auditor ordinarily would be in a position to reissue his report on the financial statements of a prior period at the request of a former client if he is able to make satisfactory arrangements with his former client to perform this service and if he performs the procedures described in paragraph .09.¹⁰

Predecessor Auditor's Report Reissued

.09 Before reissuing (or consenting to the reuse of) a report previously issued on the financial statements of a prior period, a predecessor auditor should consider whether his previous opinion on those statements is still appropriate. Either the current form or manner of presentation of the financial statements of the prior period or one or more subsequent events might make a predecessor auditor's previous opinion inappropriate. Consequently, a predecessor auditor should (a) read the financial statements of the current period, (b) compare the prior-period financial statements that he reported on with the financial statements to be presented for comparative purposes, and (c) obtain a letter of representations from the successor auditor. The letter of representations should state whether the successor's examination revealed any matters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor. Also, the predecessor auditor may wish to consider the matters described in section 543.10-12. However, the predecessor auditor should not refer in his reissued report to the report or work of the successor auditor.

.10 A predecessor auditor who has agreed to reissue his report may become aware of events or transactions occurring subsequent to the date of his previous report on the financial statements of a prior period that may affect his previous opinion (for example, the successor auditor might indicate in his response that certain matters have had a material effect on the prior-period financial statements reported on by the predecessor auditor). In such circumstances, the predecessor auditor should make inquiries and perform other procedures that he considers necessary (for example, reviewing the working papers of the successor auditor as they relate to the matters affecting the prior-period financial statements). He should then decide, on the basis of the evidential matter obtained, whether to revise his opinion. If a predecessor auditor concludes that his opinion should be revised, he should follow the guidance in paragraphs .06, .07, and .11 of this section.

¹⁰ It is recognized that there may be reasons why a predecessor auditor's report may not be reissued and this section does not address the various situations that could arise.

[11] [Deleted.]

.11 A predecessor auditor's knowledge of the current affairs of his former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing his report on prior-period financial statements, a predecessor auditor should use the date of his previous report to avoid any implication that he has examined any records, transactions, or events after that date. If the predecessor auditor revises his report or if the financial statements are restated, he should dual-date his report (see section 530.05).

Predecessor Auditor's Report Not Presented

.12 If the financial statements of a prior period have been examined by a predecessor auditor whose report is not presented, the successor auditor should indicate in the scope paragraph of his report (a) that the financial statements of the prior period were examined by other auditors,¹² (b) the date of their report, (c) the type of opinion expressed by the predecessor auditor, and (d) the substantive reasons therefor, if it was other than unqualified. An example of a successor auditor's report when the predecessor auditor's report is not presented follows:

We have examined the balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The financial statements of ABC Company for the year ended December 31, 19X1, were examined by other auditors whose report dated March 1, 19X2, expressed an unqualified opinion on those statements.

In our opinion, the 19X2 financial statements referred to above present fairly the financial position of ABC Company as of December 31, 19X2, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

If the predecessor auditor's opinion was other than unqualified, the successor auditor should describe the nature of and reasons for the qualification, as in the following example:

... were examined by other auditors whose opinion, dated March 1, 19X2, on those statements was qualified as being subject to the effects on the 19X1 financial statements of such adjustments, if any, as might have been required had the outcome of the litigation discussed in Note X to the financial statements been known.

If the financial statements of the prior period have been restated, the scope paragraph should indicate that a predecessor auditor reported on the financial

¹² The successor auditor should not name the predecessor auditor in his report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with that of, the successor auditor.

statements of the prior period before restatement. In addition, if the successor auditor is able to satisfy himself as to the appropriateness of the restatement, he may also include the following paragraph in his report:

We also reviewed the adjustments described in Note X that were applied to restate the 19XX financial statements. In our opinion, such adjustments are appropriate and have been properly applied to the 19XX financial statements.

Unaudited Financial Statements

[.13-.15] [Superseded, November 1979, by Statement on Auditing Standards No. 26.] (See section 504.)

Effective Date

.16 Statements on Auditing Standards generally are effective at the time of their issuance. However, since the provisions of this section change certain reporting practices heretofore considered acceptable, this section will be effective with respect to reports on comparative financial statements for periods ending after June 30, 1977. Nevertheless, earlier application of this section is encouraged.

AU Section 509

Reports on Audited Financial Statements

[Superseded by section 508.]

(Supersedes sections 510.01—515.10, 535.01—542.04, 544.01 and 547.01—547.04)

Sources: SAS No. 2; SAS No. 26; SAS No. 43.

See section 9508 for interpretations of this section.

Effective for reports issued on financial statements for periods ending on or after December 31, 1974, unless otherwise indicated.¹

Introduction

.01 This section applies to auditors' reports issued in connection with examinations of financial statements that are intended to present financial position, results of operations or changes in financial position in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides examples.

.02 This section does not apply to unaudited financial statements that an accountant has been engaged to prepare or assist in preparing (see section 504 *), nor does it apply to reports on incomplete or capsule financial information or on other special presentations (see section 621 **).

.03 Justification for the expression of the auditor's opinion rests on the conformity of his examination with generally accepted auditing standards and on his findings. Generally accepted auditing standards include four standards of reporting. (See section 150.02.)

This section is concerned primarily with the relationship of the fourth reporting standard to the language of the auditor's report.

.04 The fourth standard of reporting is as follows:

The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

.05 The objective of the fourth standard is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his name is associated with financial statements. Reference in the fourth reporting standard to the financial statements "taken as a whole" applies equally to a complete set

¹ See paragraph .50.

[2] [Deleted.]

* Reference changed by issuance of Statement on Auditing Standards No. 26.

** Reference changed by issuance of Statement on Auditing Standards No. 14.

of financial statements and to an individual financial statement, for example, to a balance sheet. The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances call for this treatment.

Auditor's Standard Report

.06 The auditor's report customarily is used in connection with the basic financial statements—balance sheet, statement of income, statement of retained earnings and statement of changes in financial position. If these financial statements are accompanied by a separate statement of changes in stockholders' equity accounts, it should be identified in the scope paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are included in the presentation of results of operations and changes in financial position.

.07 The auditor's standard report consists of a statement describing the nature of the examination, usually in an opening or "scope" paragraph, and an expression of the auditor's opinion, usually in a closing or "opinion" paragraph. The form of the standard report is as follows:

(Scope paragraph)

We have examined the balance sheet of X Company as of [at] December 31, 19XX, and the related statements of income, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

(Opinion paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.08 The report may be addressed to the company whose financial statements are being examined or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to examine the financial statements of a company that is not his client; in such a case, the report customarily is addressed to the client and not to the directors or stockholders of the company whose financial statements are being examined.

Circumstances Resulting in Departure From Auditor's Standard Report

.09 The circumstances that result in a departure from the auditor's standard report³ are as follows:

- a. The scope of the auditor's examination is affected by conditions that preclude the application of one or more auditing procedures he considers necessary in the circumstances.

³ As to circumstances in which the auditor is not independent, see section 504. [Reference changed by the issuance of Statement on Auditing Standards No. 26, *Association with Financial Statements*.]

- b. The auditor's opinion is based in part on the report of another auditor.
- c. The financial statements are affected by a departure from a generally accepted accounting principle.
- d. The financial statements are affected by a departure from an accounting principle promulgated by the body designated by the AICPA Council to establish such principles.
- e. Accounting principles have not been applied consistently.
- f. The financial statements are affected by uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation at the date of the auditor's report.
- g. The auditor wishes to emphasize a matter regarding the financial statements.

Scope Limitation

.10 The auditor can determine that he is able to express an unqualified opinion only if his examination has been conducted in accordance with generally accepted auditing standards and if he therefore has been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of his examination, whether imposed by the client or by circumstances such as the timing of his work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require him to qualify his opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

.11 The auditor's decision to qualify his opinion or disclaim an opinion because of a scope limitation depends on his assessment of the importance of the omitted procedure(s) to his ability to form an opinion on the financial statements examined. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved.

.12 Common restrictions on the scope of the auditor's examination include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors,⁴ but restrictions may concern other phases of the audit (for example, see section 542.06). Restrictions on the application of these or other audit procedures to important elements of the financial statements require the auditor to decide whether he has examined sufficient competent evidential matter to permit him to express an unqualified or qualified opinion, or whether he should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on the financial statements.

.13 The auditor may be asked to report on one basic financial statement and not on the others. For example, he may be asked to report on the balance sheet and not on the statements of income, retained earnings or changes in

⁴ Circumstances such as the timing of his work may make it impracticable or impossible for the auditor to accomplish these procedures. In such case, if he is able to satisfy himself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of his work, and his report need not include reference to the omission of the procedures or to the use of alternative procedures.

financial position. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if he applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

Opinion Based in Part on Report of Another Auditor

.14 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his opinion, he should disclose this fact in stating the scope of his examination and should refer to the report of the other auditor in expressing his opinion. These references indicate division of responsibility for performance of the examination. Although they are departures from the standard report language, they do not constitute a qualification of the auditor's opinion. (See section 543.)

Departure From a Generally Accepted Accounting Principle

.15 *General.* When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has examined the statements in accordance with generally accepted auditing standards, he should express a qualified or an adverse opinion (see paragraphs .29 and .41). The basis for such opinion should be stated in his report.

.16 In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or an adverse opinion, one factor to be considered is the dollar magnitude of the effects. However, materiality does not depend entirely on relative size: the concept involves qualitative as well as quantitative judgments. The significance of an item to a particular entity (e.g., inventories to a manufacturing company), the pervasiveness of the misstatement (e.g., whether it affects the amounts and presentation of numerous financial statement items), and the impact of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

.17 *Inadequate disclosure.* Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or an adverse opinion because of the departure from those principles and should provide the information in his report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards. (See section 431* regarding the adequacy of informative disclosure, and section 545.04—.05 regarding the omission of a statement of changes in financial position.) [As amended December, 1977 by Statement on Auditing Standards No. 21.] (See section 435.)

Departure From a Promulgated Accounting Principle

.18 Rule 203 [ET section 203.01] of the AICPA Code of Professional Ethics⁵ states:

A member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated

* Reference changed by issuance of Statement on Auditing Standards No. 32.

⁵ This rule supersedes the Special Bulletin of the Council of the AICPA, issued in October 1964 and referred to in the text of sections 545.04 and 546.12. [As amended July, 1975, by Statement on Auditing Standards No. 5.] (See section 411.)

by the body designated by Council to establish such principles which has a material effect on the statements taken as a whole, unless the member can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. In such cases his report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

.19 When the circumstances contemplated by Rule 203 [ET section 203.01] are present, the auditor's report should include, in a separate paragraph or paragraphs, the information required by the rule. In such a case, it is appropriate for him then to express an unqualified opinion with respect to the conformity of the financial statements with generally accepted accounting principles unless there are other reasons, not associated with the departure from a promulgated principle, to modify his report.

Accounting Principles Not Consistently Applied

.20 When there has been a change in accounting principles, the auditor should modify his opinion as to consistency. Section 546, discusses variations in report language that are appropriate when accounting principles have not been applied consistently.

Uncertainties

.21 In preparing financial statements, management is expected to use its estimates of the outcome of future events. Estimates customarily are made in connection with matters such as the useful lives of depreciable assets, the collectibility of accounts receivable, the realizable value of inventory items, and the amount of a liability for product warranty. In most cases, the auditor is able to satisfy himself regarding the reasonableness of management's estimates by considering various types of audit evidence, including the historical experience of the entity, and the relevance of the evidence in estimating the effects of future events. Matters are not to be regarded as uncertainties for purposes of this section unless their outcome is not susceptible of reasonable estimation, as discussed in paragraph .22. If the auditor, on the basis of evidence available to him, disagrees with management's determination, and if the effects on the financial statements are material, he should express a qualified or an adverse opinion because of a departure from generally accepted accounting principles.

.22 In certain instances, the outcome of matters that may affect the financial statements or the disclosures required therein is not susceptible of reasonable estimation; such matters are to be regarded as uncertainties for purposes of this section. When such uncertainties exist, it cannot be determined whether the financial statements should be adjusted, or in what amount.

.23 There may be uncertainties with respect to specific matters whose possible effects on the financial statements can be isolated and therefore readily understood. Examples are the recoverability of a deferred cost or the likelihood that a material amount will become collectible or payable because of income tax adjustments or litigation. Also, there may be multiple uncertainties or uncertainties whose possible effects are complex and whose impact on the financial statements consequently is difficult for a reader to assess. Examples of conditions indicating the existence of uncertainties of the latter kind are recurring operating losses, serious deficiencies in working capital, an inability to obtain financing sufficient for continued business operations, and failure to comply with the terms of loan agreements. In some situations an adverse outcome of matters in either category could imperil the continued

existence of the entity.⁶ In any event, if the effects of the matters on the financial statements could be material, their nature and their possible effects should be disclosed in the statements.

.24 Evidence as to the resolution of an uncertainty cannot be expected to exist at the time of the auditor's examination because the resolution, and therefore the evidence, is prospective. The auditor's function in forming an opinion on financial statements does not include estimating the outcome of future events if management is unable to do so. When there are material uncertainties, the outcome of which is not susceptible of reasonable estimation, the auditor should consider whether to express an unqualified opinion or to qualify his opinion as discussed in paragraph .25.⁷ The auditor need not modify his opinion because of the existence of an uncertainty when he concludes that there is only a minimal likelihood that resolution of the uncertainty will have a material effect on the financial statements.

.25 In cases involving uncertainties, the auditor should be able to form an opinion whether the financial statement items affected have been stated in conformity with generally accepted accounting principles in all respects other than those contingent on the outcome of the uncertainties. If he is satisfied that they have been so stated, he may appropriately express an opinion qualified by reason of the uncertainties (see paragraphs .35 and .39).⁸ If the auditor believes that the financial statement items affected by uncertainties reflect the application of accounting principles that are not generally accepted, he also should modify his report to state his reservations regarding departures from generally accepted accounting principles.

.26 The subsequent resolution of an uncertainty that has led to a modification of the auditor's opinion will (a) result in adjustment of the financial statements as to which his report originally was modified, (b) be recognized in the financial statements of a subsequent period, or (c) result in a conclusion that the matter has no monetary effect on the financial statements of any period. The qualifying expression in the opinion paragraph of the auditor's report should be the same regardless of the accounting treatment that is expected to be accorded the resolution of the uncertainty.

Emphasis of a Matter

.27 In some circumstances, the auditor may wish to emphasize a matter regarding the financial statements, but nevertheless intends to express an unqualified opinion. For example, he may wish to point out that the entity is a component of a larger business enterprise or that it has had significant transactions with related parties,* or he may wish to call attention to an unusually important subsequent event or to an accounting matter affecting the comparability of the financial statements with those of the preceding period. Such explanatory information may be presented in a separate para-

⁶ In such circumstances, the auditor is concerned with the recoverability and classification of recorded asset amounts and with the amounts and classification of liabilities. [Editor's Note: See section 340.]

⁷ The auditor may disclaim an opinion as discussed in footnote 8.

⁸ The Committee believes that the explanation of the uncertainties and the qualification of the auditor's opinion contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (see paragraph .23), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (see paragraph .45).

* [Editor's Note: See section 334. Reference changed August, 1983, by issuance of Statement on Auditing Standards No. 45.]

graph of the auditor's report. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type.

Unqualified Opinion

.28 An unqualified opinion states that the financial statements present fairly financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles (which include adequate disclosure) consistently applied (see paragraph .07). This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an examination made in accordance with generally accepted auditing standards.

Qualified Opinion

General

.29 A qualified opinion states that, "except for" or "subject to" the effects of the matter to which the qualification relates, the financial statements present fairly financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles consistently applied. Such an opinion is expressed when a lack of sufficient competent evidential matter or restrictions on the scope of the auditor's examination have led him to conclude that he cannot express an unqualified opinion, or when the auditor believes, on the basis of his examination, that

- a. the financial statements contain a departure from generally accepted accounting principles, the effect of which is material,
- b. there has been a material change between periods in accounting principles or in the method of their application, or
- c. there are significant uncertainties affecting the financial statements,

and he has decided not to express an adverse opinion or to disclaim an opinion.

.30 Ordinarily the auditor should not modify the language of the opinion paragraph of the standard report unless he is qualifying his opinion. However, reference to another auditor's report as a basis, in part, of the principal auditor's opinion is not considered to be a qualification (see paragraph .14).

.31 Financial statements, including the accompanying notes, sometimes contain unaudited information, pro forma calculations or other similar disclosures. These disclosures may be required in connection with a particular transaction (e.g., a business combination) or may otherwise be considered informative (e.g., in connection with subsequent events). If such disclosures are appropriately identified as "unaudited" or as "not covered by auditor's report," the auditor need not refer to them in his report. The reporting criteria stated in sections 504 * and 711.13 ** apply to such data. If the unaudited information (e. g., an investor's share, material in amount, of an investee's earnings recognized on the equity method) is such that it should be subjected to auditing procedures in order for the auditor to form an opinion with respect to the financial statements taken as a whole, and the auditor has not been able to apply the procedures he considers necessary, he should qualify his opinion or disclaim an opinion because of a limitation on the scope of his examination.

* Reference changed by the issuance of statement on Auditing Standards No. 26, *Association with Financial Statements*.

** Reference changed by issuance of Statement on Auditing Standards No. 37.

Report Form

.32 When the auditor intends to express a qualified opinion, he should disclose all the substantive reasons in a separate explanatory paragraph(s) of his report, and should include, in the opinion paragraph, the appropriate qualifying language and a reference to the explanatory paragraph(s). The requirement for an explanatory paragraph does not apply when the opinion paragraph has been modified because of a change in accounting principle (see paragraph .20).

.33 The explanatory paragraph(s) should disclose the principal effects of the subject matter of the qualification on financial position, results of operations and changes in financial position, if reasonably determinable. If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the explanatory paragraph(s) may be shortened by referring to it. The explanatory paragraph(s) also should make clear whether the matter is (a) one as to which there is a difference of opinion between the auditor and his client and for which the auditor believes an adjustment should be made or (b) one involving an uncertainty that cannot presently be resolved because the outcome depends on future events. If an auditor wishes to emphasize a matter or disclosure regarding the financial statements but does not intend to qualify his opinion (see paragraph .27), he should not refer to this information in the opinion paragraph of his report.

.34 When a qualified opinion results from a limitation on the scope of the examination or an insufficiency of evidential matter, the situation should be described in the explanatory paragraph and referred to in both the scope and opinion paragraphs of the auditor's report. It is not appropriate for the auditor to request that the scope of his examination be explained in a note to the financial statements, inasmuch as the description of the scope is the auditor's representation and not that of his client.

Qualifying Language

.35 A qualified opinion should include the word "except" or "exception" in a phrase such as "except for" or "with the exception of" unless the qualification arises because of an uncertainty affecting the financial statements; then the expression "subject to" should be used. Phrases such as "with the foregoing explanation" are not clear or forceful enough and should not be used. Since accompanying notes are deemed to be part of the financial statements, wording such as "fairly presented when read in conjunction with Note 1" is likely to be misunderstood and likewise should not be used.

.36 An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

(Separate paragraph)

The Company has excluded from property and debt in the accompanying balance sheet certain lease obligations, which, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$....., long-term debt by \$....., and retained earnings by \$....., as of December 31, 19XX, and net income and earnings per share would be increased (decreased) by \$..... and \$..... respectively for the year then ended.

(Opinion paragraph)

In our opinion, except for the effects of not capitalizing lease obligations, as discussed in the preceding paragraph, the financial statements present fairly. . . .

.37 If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph of the auditor's report in the circumstances illustrated in paragraph .36 might read as follows:

(Separate paragraph)

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheet. In our opinion, generally accepted accounting principles require that such obligations be included in the balance sheet.

.38 If a qualification arises because of lack of consistency in the application of accounting principles, the qualifying language should be positioned in the opinion paragraph so as to make this clear. (See section 546.)

➡ *The next page is 2215.* ⬅

.39 An example of a report qualified because of an uncertainty affecting the financial statements follows:⁹

(Separate paragraph)

As discussed in Note X to the financial statements, the company is defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the lawsuits cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

(Opinion paragraph)

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the financial statements referred to above present fairly. . . .

[As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

.40 When an auditor qualifies his opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. An example regarding inventories (assuming the effects of the limitation are not such that the auditor has concluded a disclaimer of opinion is appropriate—see paragraph .11) follows:

(Scope paragraph)

Except as explained in the following paragraph, our examination . . . and such other auditing procedures as we considered necessary in the circumstances. . . .

(Separate paragraph)

We did not observe the taking of the physical inventories as of December 31, 19XX (stated at \$.....), and December 31, 19X1 (stated at \$.....), since those dates were prior to the time we were initially engaged as auditors for the Company. Due to the nature of the Company's records, we were

⁹ The following example is appropriate in those rare instances when resolution of an uncertainty will be accounted for as a prior period of adjustment:

In our opinion, subject to the effects, if any, on the financial statements of the ultimate resolution of the matter discussed in the preceding paragraph, the financial statements referred to above present fairly. . . . [Footnote added by issuance of Statement on Auditing Standards No. 43.]

unable to satisfy ourselves as to the inventory quantities by means of other auditing procedures.¹⁰

(Opinion paragraph)

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to observe the physical inventories. . . .

Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our examination . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements, and therefore is unacceptable.

Adverse Opinion

.41 An adverse opinion states that financial statements do not present fairly the financial position, results of operations or changes in financial position in conformity with generally accepted accounting principles. Such an opinion is expressed when, in the auditor's judgment (see paragraph .16), the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles.

.42 When the auditor expresses an adverse opinion, he should disclose in a separate paragraph(s) of his report (a) all the substantive reasons for his adverse opinion and (b) the principal effects of the subject matter of the adverse opinion on financial position, results of operations and changes in financial position, if reasonably determinable. If the effects are not reasonably determinable, the report should so state. The report also should state any reservations the auditor has regarding fair presentation in conformity with generally accepted accounting principles other than those giving rise to the adverse opinion.

.43 When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.

(Separate paragraph)

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Generally accepted accounting principles, in our opinion, require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided. Because of the departures from generally accepted

¹⁰ If the auditor has been unable also to carry out other tests, such as those relating to the pricing and clerical accuracy of the inventories, the language in the separate and opinion paragraphs should be modified accordingly. [Formerly footnote number 9, number changed due to issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

accounting principles identified above, as of December 31, 19XX, inventories have been increased \$..... by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at \$..... in excess of an amount based on the cost to the Company; and allocated income tax of \$..... has not been recorded; resulting in an increase of \$..... in retained earnings and in appraisal surplus of \$..... For the year ended December 31, 19XX, cost of goods sold has been increased \$..... because of the effects of the depreciation accounting referred to above and deferred income taxes of \$..... have not been provided, resulting in an increase in net income and earnings per share of \$..... and \$..... respectively.

(Opinion paragraph)

In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19XX, or the results of its operations and changes in its financial position for the year then ended.

.44 Because an opinion as to consistency implies the application of generally accepted accounting principles, no reference to consistency should be made in the opinion paragraph when an adverse opinion is issued. However, if the auditor has specific exceptions as to consistency, these exceptions should be expressed in the report.

Disclaimer of Opinion

.45 A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. When the auditor disclaims an opinion, he should state in a separate paragraph(s) of his report all of his substantive reasons for doing so, and also should disclose any other reservations he has regarding fair presentation in conformity with generally accepted accounting principles or the consistency of their application. The disclaimer of opinion is appropriate when the auditor has not performed an examination sufficient in scope to enable him to form an opinion on the financial statements (see paragraphs .10, .11, and .12).¹¹ A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his examination, that there are material departures from generally accepted accounting principles (see paragraphs .15, .16, and .17).

.46 When expressing a disclaimer because of a significant scope limitation, the auditor should indicate in a separate paragraph(s) the respects in which

¹¹ A disclaimer may be issued in cases involving uncertainties. See the footnote to paragraph .25. If an accountant is engaged to conduct an examination of the financial statements of a nonpublic entity in accordance with generally accepted auditing standards, but is requested to change the engagement to a review or compilation of the statements, he should look to the guidance in Statement on Standards for Accounting and Review Services 1, paragraphs 44—49 [AR section 100.44—49]. [As amended, November 1979, by Statement on Auditing Standards No. 26.] (See section 504.) [Formerly footnote number 10, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

his examination did not comply with generally accepted auditing standards. He should state that the scope of his examination was not sufficient to warrant the expression of an opinion. The auditor should not indicate the procedures performed; to do so may tend to overshadow the disclaimer.

.47 An example of a disclaimer resulting from an inability to obtain sufficient competent evidential matter follows:

(Scope paragraph)

... Except as set forth in the following paragraph, our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

(Separate paragraph).

The Company did not take a physical inventory of merchandise, stated at \$..... in the accompanying financial statements as of December 31, 19XX, and at \$..... as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19XX is no longer available. The Company's records do not permit the application of adequate alternative procedures regarding the inventories or the cost of property and equipment.

(Disclaimer paragraph)

Since the Company did not take physical inventories and we were unable to apply adequate alternative procedures regarding inventories and the cost of property and equipment, as noted in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to above.

Piecemeal Opinion

.48 Piecemeal opinions (expressions of opinion as to certain identified items in financial statements) sometimes have been issued heretofore when the auditor disclaimed an opinion or expressed an adverse opinion on the financial statements taken as a whole.¹² Because piecemeal opinions tend to overshadow or contradict a disclaimer of opinion or an adverse opinion,¹³ they are inappropriate and should not be issued in any situation.

¹² The use of a piecemeal opinion following a disclaimer of opinion has not been permitted when the disclaimer was occasioned by a significant client-imposed restriction on audit scope. [Formerly footnote number 11, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

¹³ In view of the provisions of this paragraph, the last sentence of section 544.02, having to do with companies whose accounting practices are prescribed by governmental regulatory authorities or commissions, is amended to read as follows:

An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles.

[Formerly footnote number 12, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

Reports on Comparative Statements

[.49] [Superseded by Statement on Auditing Standards No. 15, effective for periods ending after June 30, 1977.] (See section 505.)

Effective Date

.50 Statements on Auditing Standards generally are effective at the time of their issuance. However, since the provisions of this section change certain reporting practices heretofore considered acceptable, this section will be effective with respect to reports issued on financial statements for periods ending on or after December 31, 1974, and need not be applied retroactively. The Committee understands that arrangements already may have been made for certain engagements, at the conclusion of which the auditor customarily has expressed a piecemeal opinion following a disclaimer of opinion occasioned by scope limitations. In order to provide a period of orderly transition, since the use of piecemeal opinions will no longer be appropriate under the provisions of paragraph .48 of this section, the provisions of that paragraph will be effective with respect to reports issued on financial statements for periods ending on or after January 31, 1975.

➤→ *The next page is 2221.* ←➤

^[14] [Superseded by Statement on Auditing Standards No. 15, effective for periods ending after June 30, 1977.] (See section 505.) [Formerly footnote number [13], number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

AU Section 542***Other Conditions Which
Preclude the Application
of Necessary Auditing
Procedures***

[Superseded by section 508.]

Source: SAS No. 1, section 542.

Issue date, unless otherwise indicated: November, 1972.

Receivables and Inventories

[.01—.04] [Superseded by Statement on Auditing Standards No. 2, effective December 31, 1974.] (See section 509.)

.05 If the independent auditor has not satisfied himself by means of other auditing procedures with respect to opening inventories, he should either disclaim an opinion on the statement of income or qualify his opinion thereon, depending on the degree of materiality of the amounts involved. An illustration of such a disclaimer follows:

(Scope paragraph)

We have examined the balance sheet of X Company as of September 30, 19..2, and the related statements of income and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except as stated in the following paragraph.

(Middle paragraph)

Because we were not engaged as auditors until after September 30, 19..1, we were not present to observe the physical inventory taken at that date and we have not satisfied ourselves by means of other procedures concerning inventory quantities. The amount of the inventory at September 30, 19..1, enters materially into the determination of the results of operations and changes in financial position for the year ended September 30, 19..2. Therefore, we do not express an opinion on the accompanying statements of income and retained earnings and changes in financial position for the year ended September 30, 19..2.

(Opinion paragraph)

In our opinion, the accompanying balance sheet presents fairly the financial position of X Company at September 30, 19..2, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.¹

¹ It is assumed that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles (see section 420 for a discussion of consistency).

Long-Term Investments

.06 When the effects of accounting for long-term investments are material in relation to financial position or results of operations of the investor, the independent auditor is not in a position to express an unqualified opinion on the investor's financial statements unless he has obtained sufficient competent evidential matter in support of the objectives described in section 332.02. There may be situations where there is an effective limitation on the scope of the auditor's examination because sufficient evidential matter is not available to him. Examples of such scope limitations, generally with respect to investments accounted for under the equity method, would be (a) the auditor not being able to obtain audited financial statements of an investee or to apply auditing procedures to unaudited financial statements of an investee and (b) the auditor not being able to examine sufficient evidential matter relating to the elimination of unrealized profits and losses resulting from transactions between the investor and the investee. In such situations, the auditor should indicate in the scope paragraph of his report the limitations on his work and, depending on materiality of the amounts involved, he should either qualify his opinion or disclaim an opinion.

AU Section 545

Inadequate Disclosure

[Superseded by section 508.]

Sources: SAS No. 1, section 545; SAS No. 21.

Issue date, unless otherwise indicated: November, 1972.

.01 Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or an adverse opinion because of the departure from those principles and should provide the information in his report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards. [As amended December, 1977 by Statement on Auditing Standards No. 21.] (See section 435.)

.02 An illustration of appropriate wording in such instances follows:

(Middle paragraph)

On January 15, 19..2, the company issued debentures in the amount of \$..
..... for the purpose of financing plant expansion. The debenture
agreement restricts the payment of future cash dividends to earnings after
December 31, 19..1.

(Opinion paragraph)

In our opinion, except for the omission of the information in the preceding
paragraph, the aforementioned financial statements present fairly . . .

.03 There may be instances where the independent auditor may wish to include in his report additional explanatory matter (which is not required for adequate disclosure) to highlight certain circumstances or to aid in the interpretation of the financial statements. Since such additional disclosure is not intended to qualify the scope of examination or the opinion on the statements, no reference thereto should be made in the opinion paragraph of the independent auditor's report.

Omission of Statement of Changes in Financial Position

.04 If an entity issues financial statements that purport to present financial position and results of operations but omits the related statement of changes in financial position, and if the omission is not sanctioned by Opinion No. 19 [AC section F40] of the Accounting Principles Board, the omission should be treated in accordance with the provisions of the Special Bulletin of the American Institute of Certified Public Accountants issued in October 1964 relating to disclosures of departures from Opinions of the Accounting Princi-

ples Board.¹ Accordingly, the auditor normally will conclude that the omission requires qualification of his opinion.

.05 If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should provide the information in his report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards. The auditor is not required to prepare a basic financial statement (a statement of changes in financial position for one or more years) and include it in his report if an entity declines to present the statement. Accordingly, in these cases the auditor should qualify his report, ordinarily in the following manner:

We have examined the balance sheet of X Company as of December 31, 19....., and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The company declined to present a statement of changes in financial position for the year ended December 31, 19..... Presentation of such statement summarizing the company's financing and investing activities and other changes in its financial position is required by Opinion No. 19 of the Accounting Principles Board.

In our opinion, except that the omission of a statement of changes in financial position results in an incomplete presentation as explained in the preceding paragraph, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19....., and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

[As amended December, 1977 by Statement on Auditing Standards No. 21.]
(See section 435.)

¹ EDITOR'S NOTE: Effective March 1, 1973, members of the Institute are governed by Rule of Conduct 203 [ET section 203.01] of the Code of Professional Ethics of the Institute in reporting on financial statements materially affected by a departure from an accounting principle promulgated by the body designated by Council of the Institute to establish generally accepted accounting principles.

AU Section 546

Reporting on Inconsistency

[Superseded by section 508.]

Source: SAS No. 1, section 546.

Issue date, unless otherwise indicated: November, 1972.

Change in Accounting Principle

.01 When there is a change in accounting principle, the independent auditor should modify his opinion as to consistency, indicating the nature of the change. The auditor's concurrence with a change is implicit unless he takes exception to the change in expressing his opinion as to fair presentation of the financial statements in conformity with generally accepted accounting principles. Nevertheless, in order to be more informative the auditor should make his concurrence explicit (unless the change is the correction of an error*) using the expression "with which we concur." The form of modification of the opinion depends on the method of accounting for the effect of the change, as explained in paragraphs .02 and .03.¹

.02 If there has been a change in accounting principle which should be reported by restating the financial statements of prior years,² the appropriate reference to consistency is that the statements are consistent after giving retroactive effect to the change. Illustrations of appropriate reporting follow:

(Opinion paragraph covering one year)

... applied on a basis consistent with that of the preceding year after giving retroactive effect to the change, with which we concur, in the method of accounting for long-term construction contracts as described in Note X to the financial statements.

(Opinion paragraph covering two years)

... applied on a consistent basis after restatement for the change, with which we concur, in the method of accounting for long-term construction contracts as described in Note X to the financial statements.

The auditor's report need not refer to a change in accounting principle and restatement made in conformity with generally accepted accounting principles if the statements for the year of change are reported upon together with the financial statements for a year subsequent to the year of change.

.03 If there has been a change in accounting principle which should be reported by means other than by restating the financial statements of prior years and the independent auditor is reporting only on the year during which the change was made, his report should state that accounting principles have been consistently applied except for the change. An example of such reporting follows:

* See section 420.10.

¹ With respect to the method of accounting for the effect of a change in accounting principle, see Accounting Principles Board Opinion No. 20 [AC section A06], including paragraph 4, which states that methods of accounting for changes in principles have been and will be specified in pronouncements other than Opinion No. 20 [AC section A06].

² With respect to reporting on financial statements after a pooling of interests, see paragraphs .12 and .13 and section 543.16—17.

(Opinion paragraph)

... in conformity with generally accepted accounting principles which, except for the change, with which we concur, in the method of computing depreciation as described in Note X to the financial statements, have been applied on a basis consistent with that of the preceding year.

If the independent auditor is reporting on two or more years when reporting on a subsequent year's financial statements, he should make appropriate reference to the change as long as the year of change is included in the years being reported upon. If the year of change was other than the earliest year being reported upon, the following example would be an appropriate form of reporting:

(Opinion paragraph)

... in conformity with generally accepted accounting principles consistently applied during the period except for the change, with which we concur, in the method of computing depreciation as described in Note X to the financial statements.

If the year of change is the earliest year being reported upon, there is no inconsistency in the application of accounting principles during the period subsequent to the change. However, the auditor should make reference to the change having been made in such year when a cumulative effect adjustment is included in the income statement for the year of the change. Following is an example of appropriate reporting:

(Opinion paragraph)

... in conformity with generally accepted accounting principles consistently applied during the period subsequent to the change, with which we concur, made as of January 1, 19....., in the method of computing depreciation as described in Note X to the financial statements.

A change in accounting principle made at the beginning of the year preceding the earliest year being reported upon by the auditor does not result in an inconsistency between such preceding year and later years. In reporting on consistency of a later year with such preceding year, reference to a change is not necessary.

[As modified, November 1979, by the Auditing Standards Board.]

Reporting on Changes in Accounting Principle That Are Not in Conformity With Generally Accepted Accounting Principles

.04 The auditor should evaluate a change in accounting principle to satisfy himself that (a) the newly adopted accounting principle is a generally accepted accounting principle, (b) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, and (c) management's justification³ for the change is reasonable. If a change in accounting principle does not meet these conditions, the auditor's report should so indicate and his opinion should be appropriately qualified as discussed in paragraphs .05 through .11.

Reporting in the Year of Change

.05 If a newly adopted accounting principle is not a generally accepted accounting principle or the method of accounting for the effect of the change is not in conformity with generally accepted accounting principles, the auditor should express a qualified opinion or, if the effect of the change is sufficiently material, the auditor should express an adverse opinion on the financial statements taken as a whole due to a lack of conformity with generally accepted accounting principles. If a qualified opinion is expressed, the qualification would relate both to conformity with generally accepted accounting principles and to the consistency of application. When expressing an adverse opinion in such circumstances, no reference to consistency need be made because the financial statements are not presented in conformity with generally accepted accounting principles.⁴ Following is an illustration of reporting where the newly adopted accounting principle is not a generally accepted accounting principle:

(Middle paragraph)

The company previously recorded its land at cost but adjusted the amounts to appraised values during the year, with a corresponding increase in stockholders' equity in the amount of \$..... In our opinion, the new basis on which land is recorded is not in conformity with generally accepted accounting principles.

³ Accounting Principles Board Opinion No. 20, paragraph 16 [AC section A06.112], states: "The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable." The requirement for justification is applicable to years beginning after July 31, 1971.

⁴ Note disclosure of an inconsistency in accounting principles unrelated to the reason for an adverse opinion is required even though the independent auditor does not refer to the inconsistency in his report. If such an inconsistency is not disclosed, the independent auditor should also qualify his report for this lack of disclosure. [See section 431 (reference changed by issuance of Statement on Auditing Standards No. 32).]

(Opinion paragraph)

In our opinion, except for the change to recording appraised values as described above, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19....., and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.06 If management has not provided reasonable justification for a change in accounting principles, the independent auditor should express an exception to the change having been made without reasonable justification. Such qualification would relate both to conformity with generally accepted accounting principles and to the consistency of application. An example follows:

(Middle paragraph)

As disclosed in Note X to the financial statements, the company has adopted (description of newly adopted method), whereas it previously used (description of previous method). Although use of the (description of newly adopted method) is in conformity with generally accepted accounting principles, in our opinion the company has not provided reasonable justification for making a change as required by Opinion No. 20 of the Accounting Principles Board.

(Opinion paragraph)

In our opinion, except for the change in accounting principles as stated above, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19....., and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Reporting in Subsequent Years

.07 Whenever an accounting change results in an independent auditor expressing a qualified or adverse opinion on the conformity of financial statements with generally accepted accounting principles for the year of change, he should consider the possible effects of that change when reporting on the entity's financial statements for subsequent years, as discussed in paragraphs .08—.11.

.08 If the financial statements for the year of such change are presented with a subsequent year's financial statements, the auditor's report should disclose his reservations with respect to the statements for the year of change.

.09 If an entity has adopted an accounting principle which is not a generally accepted accounting principle, its continued use may have a material effect on the statements of a subsequent year on which the auditor is reporting. In this situation, the independent auditor should express either a

qualified or an adverse opinion, depending upon the materiality of the departure in relation to the statements of the subsequent year.

.10 If an entity accounts for the effect of a change prospectively when generally accepted accounting principles require restatement or the inclusion of the cumulative effect of the change in the year of change, a subsequent year's financial statements could improperly include a charge or credit which is material to those statements. This situation also requires that the auditor express a qualified or an adverse opinion.

.11 If management has not provided reasonable justification for a change in accounting principles, the auditor's opinion should express an exception to the change having been made without reasonable justification, as previously indicated. In addition, the auditor should continue to express his exception with respect to the financial statements for the year of change as long as they are presented. However, the auditor's exception relates to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing an exception for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express an exception to use of the newly adopted principle.

Reports Following a Pooling of Interests

.12 When companies have merged or combined in accordance with the accounting concept known as a "pooling of interests," appropriate effect of the pooling should be given in the presentation of financial position, results of operations, changes in financial position, and other historical financial data of the continuing business for the year in which the combination is consummated and, in comparative financial statements, for years prior to the year of pooling, as described in Accounting Principles Board Opinion No. 16 [AC section B50], "Business Combinations." If prior year financial statements, presented in comparison with current year financial statements, are not restated to give appropriate recognition to a pooling of interests, the comparative financial statements are not presented on a consistent basis. In this case, the inconsistency arises not from a change in the application of an accounting principle in the current year, but from the lack of such application to prior years. Such inconsistency would require a qualification in the independent auditor's report. In addition, failure to give appropriate recognition to the pooling in comparative financial statements is a departure from an Opinion of the Accounting Principles Board. Therefore, the auditor must also give appropriate consideration to the provisions of the Special Bulletin of the American Institute of Certified Public Accountants issued in October 1964 relating to disclosures of departures from Opinions of the Accounting Principles Board.⁵

⁵ EDITOR'S NOTE: Effective March 1, 1973, members of the Institute are governed by Rule of Conduct 203 [ET section 203.01] of the Code of Professional Ethics of the Institute in reporting on financial statements materially affected by a departure from an accounting principle promulgated by the body designated by Council of the Institute to establish generally accepted accounting principles.

.13 When single-year statements only are presented for the year in which a combination is consummated, a note to the financial statements should adequately disclose the pooling transaction and state the revenues, extraordinary items, and net income of the constituent companies for the preceding year on a combined basis. In such instances, the disclosure and consistency standards are met. Omission of disclosure of the pooling transaction and its effect on the preceding year would require qualifications as to the lack of disclosure and consistency in the independent auditor's report.

First Examinations

.14 When the independent auditor has not examined the financial statements of a company for the preceding year, he should adopt procedures that are practicable and reasonable in the circumstances to assure himself that the accounting principles employed are consistent between the current and the preceding year. Where adequate records have been maintained by the client, it is usually practicable and reasonable to extend auditing procedures sufficiently to give an opinion as to consistency.

.15 Inadequate financial records or limitations imposed by the client may preclude the independent auditor from forming an opinion as to the consistent application of accounting principles between the current and the prior year, as well as to the amounts of assets or liabilities at the beginning of the current year. Where such amounts could materially affect current operating results, the independent auditor would also be unable to express an opinion on the current year's results of operations and changes in financial position. Following is an example of reporting where the records are inadequate:

(Scope paragraph)

... and such other auditing procedures as we considered necessary in the circumstances, except as indicated in the following paragraph.

(Middle paragraph)

Because of major inadequacies in the Company's accounting records for the previous year, it was not practicable to extend our auditing procedures to enable us to express an opinion on results of operations and changes in financial position for the year ended (current year) or on the consistency of application of accounting principles with the preceding year.

(Opinion paragraph)

In our opinion, the accompanying balance sheet presents fairly the financial position of X Company as of (current year end) in conformity with generally accepted accounting principles.

.16 If accounting records for prior years were kept on a basis which did not result in a fair presentation of financial position, results of operations, and

changes in financial position in conformity with generally accepted accounting principles for those years, and it is impracticable to restate financial statements for those years,⁶ the independent auditor should omit the customary reference to consistency and present his report similar to the following:

(Middle paragraph)

The Company has kept its records and has prepared its financial statements for previous years on the cash basis with no recognition having been accorded accounts receivable, accounts payable, or accrued expenses. At the beginning of the current year the Company adopted the accrual basis of accounting. Although appropriate adjustments have been made to retained earnings as of the beginning of the year, it was not practicable to determine what adjustments would be necessary in the financial statements of the preceding year to restate results of operations and changes in financial position in conformity with the accounting principles used in the current year.

(Opinion paragraph)

In our opinion, the aforementioned financial statements present fairly the financial position of X Company as of October 31, 19...., and the results of its operation and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles.

Pro Forma Effects of Accounting Changes

.17 In single-year financial statements, the pro forma effects of retroactive application of certain accounting changes should be disclosed.⁷ In such situations, the reporting provisions of section 505* are applicable to the prior year data.

➡ *The next page is 2233.* ⬅

⁶ If restatement of prior years' statements is practicable, see section 420.10.

⁷ See paragraph 21 of Accounting Principles Board Opinion No. 20 [AC section A06.117].

* Reference changed by issuance of Statement on Auditing Standards No. 15.

AU Section 642

Reporting on Internal Accounting Control

[.01—.46] [These paragraphs have not been superseded by AU section 325, *Communication of Internal Control Structure Related Matters Noted in an Audit.*]

Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit

.47 As discussed earlier, the purpose and, generally, the scope of an independent accountant's engagement to express an opinion on an entity's system of internal accounting control differ from those of a study and evaluation of internal accounting control made in an examination of financial statements in accordance with generally accepted auditing standards.

.48 Nevertheless, the auditor may be requested to report on internal accounting control based solely on the study and evaluation made in an audit of financial statements even though it is not sufficient for expressing an opinion on the system taken as a whole. The auditor may report in these circumstances, provided the report indicates that it is intended solely for management, a specified regulatory agency, or other specified third party,⁷ and that the report describes the limited purpose of the study and evaluation and disclaims an opinion on the system of internal accounting control taken as a whole.⁸

.49 The following is an illustration of an auditor's report on internal accounting control when the study and evaluation made as part of the audit is not sufficient for expressing an opinion on the system taken as a whole.

To the Board of Directors of XYZ Company:

We have examined the financial statements of XYZ Company for the year ended December 31, 19X1, and have issued our report thereon dated February 23, 19X2.⁹ As part of our examination, we made a study and

⁷ This form of reporting is appropriate, even though by law or regulation the accountant's report may be made a matter of public record.

⁸ When the study and evaluation made as part of an audit is sufficient for expressing an opinion on the system, the auditor may report in accordance with paragraphs .37 through .46.

⁹ If the report on an examination of the financial statements is qualified because of a restriction on the scope of the examination, the restriction and its effect on the evaluation of the system of internal accounting control should be indicated in the report. If a portion of the examination has been performed by other auditors, the principal auditor's report should make it clear that it does not cover the entities examined by the other auditors. If the other auditors have issued a report concerning material weaknesses, the principal auditor may wish to, but is not required to, refer to such report of the other auditors.

evaluation of the Company's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the company's financial statements. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting control taken as a whole.

The management of XYZ Company is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of XYZ Company taken as a whole. However, our study and evaluation disclosed no condition that we believed to be a material weakness.

This report is intended solely for the use of management (or specified regulatory agency or other specified third party) and should not be used for any other purpose.

.50 If the study and evaluation discloses material weaknesses (as defined in section 323, as amended), the report should describe the weaknesses that have come to the auditor's attention and state that they were considered in determining the audit tests to be applied in the examination of financial statements. The last sentence of the fourth paragraph of the illustrative report should be modified as follows:

However, our study and evaluation disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements of XYZ Company may occur and not be detected within a timely period. (A description of the material weaknesses that have come to the auditor's attention would follow.)

These conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in our examination of the 19X1 financial statements, and this report does not affect our report on these financial statements dated (date of report).

.51 The auditor may want to report other weaknesses even though they are not considered to be material. Comments on such weaknesses should be clearly distinguished from those relating to material weaknesses. If some weaknesses are reported to one group but not to another (for example, to management but not to regulatory agencies), the more extensive report should distinguish the weaknesses that are excluded from the other report, and the auditor should be prepared to support, if necessary, his judgment in making the distinction.

.52 In some cases reports on internal accounting control may include comments on additional matters. For example, a regulatory agency may require comments on certain aspects of administrative control or on compliance with certain provisions in contracts or regulations. In such cases the language in paragraph .49 should be modified to identify clearly the additional matters and distinguish them from internal accounting control, to describe in reasonable detail the scope of the review and tests concerning them, and to express conclusions in language comparable to that in paragraphs .49 and .50 as appropriate. The identification of the additional matters covered in the report should be as specific as the auditor considers necessary to prevent misunderstanding in this respect. Such identification can be made in some cases by reference to specific portions of other documents such as contracts or regulations.

.53 Suggestions or other comments concerning specific aspects of internal accounting control and various other matters are often submitted to management by auditors as a result of observations made during their examinations of financial statements. These comments are often submitted by letters, memoranda, and other less formal means. This practice is encouraged, and this section is not intended to preclude the use of such means of communication.

[.54—.62] [These paragraphs have not been superseded by AU section 325, *Communication of Internal Control Structure Related Matters Noted in an Audit.*]

➡ The next page is 2237. ⬅

AU Section 9318***Analytical Review Procedures:
Auditing Interpretations of
AU Section 318***

See section 9329, *Analytical Procedures: Auditing Interpretations of AU Section 329* for the interpretations of section 318.

➤➤➤➤➤ ➤ *The next page is 2239.* ←➤➤➤➤➤

AU Section 9320***The Auditor's Study and
Evaluation of Internal Control:
Auditing Interpretations of
AU Section 320*****1. Dual-Purpose Tests**

.01 *Question*—Section 320.62 states that the purpose of compliance tests is to provide reasonable assurance that the accounting control procedures are being applied as prescribed. Section 320.79 states that the purpose of substantive tests is to obtain evidence as to the validity and the propriety of accounting treatment of transactions and balances or, conversely, of errors or irregularities therein. Often the specific auditing procedures applied in a compliance test are similar to those used in a substantive test and vice versa. When is a compliance test or a substantive test also considered a dual-purpose test?

.02 *Interpretation*—Although the purposes of compliance and substantive tests differ, both purposes often are accomplished concurrently through tests of details. In that case, the test of details would be a dual-purpose test. (See section 320.79.) In practice situations, the results of compliance tests provide evidence relative to the achievement of the objective stated in section 320.62 and some may also provide evidence that contributes to the achievement of the objective of substantive tests stated in section 320.79. Similarly, the results of substantive tests provide evidence relative to the achievement of their objective and some may also provide evidence that contributes to the achievement of the objective of compliance tests. However, the tests would not be considered dual-purpose tests unless they accomplish the purposes of both tests concurrently.

.03 To achieve compliance and substantive objectives concurrently in a dual-purpose test, the auditor ordinarily should design the test for that purpose. Section 350, *Audit Sampling* paragraph .43 (AU section 350.43), discusses factors an auditor would consider when designing an audit sample that will achieve the objectives of both compliance and substantive testing.

[Issue Date: May, 1985.]

2. Selection of Compliance Test Procedures

.04 *Question*—Section 320.62 states that the purpose of compliance tests is to provide reasonable assurance that accounting control procedures are being applied as prescribed. Is there one specific compliance test that must always be performed to enable the auditor to obtain reasonable assurance that accounting control procedures are being applied as prescribed (e. g., is reperformance of the accounting control procedure required)?

.05 *Interpretation*—No one specific compliance test, such as reperformance of an accounting control, is always required to obtain reasonable assurance that accounting control procedures are being applied as prescribed. The auditor selects his auditing procedures for tests of compliance from a variety of testing techniques, for example inquiry, observation, inspection and reperformance of an accounting control procedure.¹ The selection of the appropriate auditing procedure(s) to be used in a specific compliance test is a matter for the auditor's judgment. In selecting the auditing procedure(s), the auditor should consider factors such as:

- ☐ The nature of the accounting control procedure being tested and related evidence, i. e., audit trail (e. g., the selection of the auditing procedure(s) may depend on whether the accounting control procedure is performed manually or by a computer application program and on the extent of evidence available to support performance of the accounting control procedure).
- ☐ The ability of a specific auditing procedure to identify control deviations separately or in combination with other auditing procedures to be performed.

.06 The selection of appropriate auditing procedures to test specific accounting control procedures may also be related to the auditor's planned degree of reliance on internal accounting controls, (e. g., substantial reliance, moderate reliance, or minimum reliance). As the auditor's planned degree of reliance on the control procedure increases, the nature, timing, and/or extent of planned compliance tests often change.

[Issue Date: May, 1985.]

¹ Inquiry and observation procedures may be used in the preliminary phase of the review of the system of internal accounting control, in completing the review and for tests of compliance with accounting control procedures. In the review phases, inquiries and observations, if used, are designed to obtain an understanding of the system. In the compliance test phase, inquiry and observation procedures are generally more extensive and are designed to obtain assurance that accounting control procedures are being applied as prescribed (e. g., initial inquiries and interviews that are directed to managerial or supervisory level personnel may be corroborated through inquiry and observation of the personnel who actually perform the control procedures.)

AU Section 9328***Illegal Acts by Clients:
Auditing Interpretations
of AU Section 328***

See section 9317, *Illegal Acts by Clients: Auditing Interpretations of AU Section 317* for the interpretations of section 328.

➤➤➤→ *The next page is 2243.* ←➤➤➤

AU Section 9505***Reports on Comparative Financial Statements: Auditing Interpretations of AU Section 505*****1. Updated Reports Resulting from the Retroactive Suspension of Earnings per Share and Segment Information Disclosure Requirements**

See section 9508.44—.48, *Reports on Audited Financial Statements: Auditing Interpretations of AU Section 508* for the interpretations of Section 505.

2. Restating Financial Statements Reported on by a Predecessor Auditor

[.06—.07] [An Interpretation of section 315, *Communications Between Predecessor and Successor Auditors*, and section 505, *Reports on Comparative Financial Statements*, entitled *Restating Financial Statements Reported on by a Predecessor Auditor*, can be found in section 9315.06—.07.]

[Issue Date: September, 1986.]

»»»→ The next page is 2245. ←«««

AU Section 9509

Reports on Audited Financial Statements: Auditing Interpretations of AU Section 509

1. Report of an Outside Inventory-Taking Firm as an Alternative Procedure for Observing Inventories

See section 9508, *Reports on Audited Financial Statements: Auditing Interpretations of AU Section 508* for this interpretation.

[2.] Reporting on Comparative Financial Statements of Nonprofit Organizations

[.07—.10] [Superseded by Statement on Auditing Standards No. 15, effective for periods ending after June 30, 1977.] (See section 505.)

3. Reporting on Loss Contingencies

.11 *Question*—Statement on Financial Accounting Standards No. 5,* “Accounting for Contingencies,” of the Financial Accounting Standards Board specifies criteria for accruing and disclosing loss contingencies. What is the relationship between the criteria established in Statement No. 5 [AC section C59] and the auditor’s reporting obligations when the financial statements on which he is reporting are affected by such uncertainties?

.12 *Interpretation*—In discussing loss contingencies Statement No. 5 [AC section C59] uses the terms *probable*, *reasonably possible* and *remote* to describe different degrees of likelihood that future events will confirm a loss or an impairment of an asset or incurrence of a liability and the accounting standards for accrual and disclosure are based on those terms. Paragraph 3 [AC section C59.104] of that Statement defines those terms as follows:

Probable. The future event or events are likely to occur.

Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

Remote. The chance of the future event or events occurring is slight.

* AC section C59.

.13 Section 509.22 states: "In certain instances, the outcome of matters that may affect the financial statements or the disclosures required therein is not susceptible of reasonable estimation; such matters are to be regarded as uncertainties. . . ." Section 509.24 states: "The auditor need not modify his opinion because of the existence of an uncertainty when he concludes that there is only a minimal likelihood that resolution of the uncertainty will have a material effect on the financial statements." The meaning of "minimal likelihood" as used in section 509 is equivalent to "remote" as used in FASB Statement No. 5.* Consequently, an independent auditor need not modify his opinion because of the existence of an uncertainty when he concludes that there is only a remote likelihood that resolution of the uncertainty will have a material effect on the financial statements on which he is reporting.

.14 When a future event or events that will resolve an existing contingency are reasonably possible (chance of occurrence is more than remote but less than likely) and the amount of the potential liability cannot be estimated, the auditor might modify his opinion if he concludes the potential effect of the resolution of the uncertainty is material. When the events that will resolve a contingency are probable (likely to occur), but the amount of the loss cannot be estimated, an uncertainty exists. In this case, the auditor should modify his opinion when he believes that the resolution of the uncertainty will have material effect on the financial statements he is examining.

[Issue Date: January, 1976.]

[4.] Reports on Consolidated Financial Statements That Include Supplementary Consolidating Information

[.15—.20] [Superseded December 31, 1980, by SAS No. 29.]
(See section 551.)

5. Disclosures of Subsequent Events

.21 *Question*—Section 509.31 on "Reports on Audited Financial Statements" states that notes to financial statements may contain "un-audited information, pro forma calculations or other similar disclosures. These disclosures may be required in connection with a particular transaction (e. g., a business combination) or may otherwise be considered informative (e. g., in connection with subsequent events)." Does this mean that a note on a subsequent event which should be disclosed may be labeled unaudited?

.22 *Interpretation*—No. Section 530.05 states that if the auditor is aware of a material subsequent event that has occurred after the

* AC section C59.

completion of field work but before issuance of the report which should be disclosed, the only options are to dual date the report or date the report as of the date of the subsequent event and extend the procedures for review of subsequent events to that date. Labeling the note unaudited is not an acceptable alternative in these circumstances.

.23 Section 560.05 states that a subsequent event "may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet." For example, the auditor may decide that disclosure of a business combination or the destruction of assets after the date of the financial statements should be made by presenting the pro forma effect in a note to the financial statements. It is such pro forma presentation of the effects of a subsequent event that may be marked unaudited. Thus, although a note describing a subsequent event may include unaudited information which is appropriately labeled, the information on the event itself should not be marked unaudited.

.24 However, according to section 530.08 a note disclosing a subsequent event may be labeled unaudited when the event occurs between the date of the independent auditor's original report and the date of the reissuance of such report.

[Issue Date: July, 1979.]

6. The Materiality of Uncertainties

.25 *Question*—Section 509.24 states that "When there are material uncertainties, the outcome of which is not susceptible of reasonable estimation, the auditor should consider whether to express an unqualified opinion or to qualify his opinion. . . ." What approach should the auditor use in considering whether the potential effect of an uncertainty is material?

.26 *Interpretation*—Materiality is a relative concept and the basis of comparison is thus an important aspect of the auditor's consideration of whether an uncertainty is material. Some uncertainties relate primarily to financial position while others more closely relate to results of operations. Thus the auditor should consider the potential effect on the financial statement that is most appropriate in the circumstances.

.27 Some uncertainties are unusual in nature or infrequent in occurrence and thus more closely related to financial position than to normal, recurring operations. Examples include the recoverability of start-up costs and litigation relating to alleged violations of antitrust or securities laws. In such instances the auditor should

evaluate the materiality of the uncertainty by comparing the potential effect to shareholders' equity and also to other relevant balance sheet components such as total assets, total liabilities, current assets or current liabilities.

.28 In other instances the nature of an uncertainty may be more closely related to normal, recurring operations, for example, litigation with a party to a royalty agreement concerning whether a royalty fee should be paid on certain revenues, and revenues of certain public utilities collected subject to refund. In such circumstances it is appropriate to consider the materiality of the uncertainty in relation to the potential effect on the income statement.

[Issue Date: October, 1979.]

[7.] Reporting on an Uncertainty

[.29—.32] [Withdrawn August, 1982 by Statement on Auditing Standards No. 43.]

8. Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting

See section 9508, *Reports on Audited Financial Statements: Auditing Interpretations of AU Section 508* for this interpretation.

9. Quantifying Departures From Generally Accepted Accounting Principles

.39 *Question*—Section 509, *Reports on Audited Financial Statements*, paragraphs .32 and .33, states that if the auditor intends to express a qualified opinion because of a departure from generally accepted accounting principles he should disclose all the substantive reasons in a separate explanatory paragraph of his report. The paragraph should disclose the principal effects of the subject matter of the qualification if "reasonably determinable" unless its omission from the auditor's report is recognized as appropriate by a specific SAS. Section 509.42 provides similar guidance to an auditor when he expresses an adverse opinion.

.40 Under what circumstances may an auditor conclude that it is not "reasonably determinable" to quantify a departure from generally accepted accounting principles?

.41 *Response*—Section 509.17 states that if the financial statements fail to disclose information required by generally accepted accounting principles, the auditor should express a qualified or an adverse opinion because of the departure from generally accepted

accounting principles and should provide the information in his report, if "practicable," unless its omission from the auditor's report is recognized as appropriate by a specific SAS. In discussing this issue, section 431, *Adequacy of Disclosure in Financial Statements*, defines "practicable" as: "... the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information."

.42 Similar guidance applies when the auditor expresses a qualified or an adverse opinion because of a departure from generally accepted accounting principles that is not related to disclosure.

.43 Management is responsible for the fair presentation of financial statements in conformity with generally accepted accounting principles. The auditor is not required to assume the position of a preparer of financial statements and therefore is not required to present information that management has not prepared or that is not reasonably obtainable from the accounts and records. However, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the examination, the information should be presented in his report.

[Issue Date: April, 1986.]

➤➤➤→ *The next page is 2247.* ←➤➤➤

AU Section 9642

Reporting on Internal Accounting Control: Auditing Interpretations of AU Section 642

[1.—6.] [These interpretations have not been superseded by section 325, *The Communication of Internal Control Related Matters Noted in an Audit*. See AU Section 9642 under “Auditing Interpretations”.]

7. Report Required by U. S. General Accounting Office

.18 *Question*—Section 642, “Reporting on Internal Accounting Control,” paragraph .48, states that an auditor may be requested by a specified regulatory agency to report on internal accounting control based solely on a study and evaluation made in an audit of financial statements. The United States General Accounting Office’s (GAO) “Standards for Audit of Governmental Organizations, Programs, Activities and Functions,” 1981 revision (the Yellow Book), requires such a report on the study and evaluation of internal accounting controls made as part of the financial and compliance audit, and it makes reference to the sample report given in section 642.49. The GAO reporting standards, however, go beyond section 642 and require the auditor to identify in his report the entity’s significant accounting controls and those controls identified that were and were not evaluated.¹ How should the auditor identify and classify accounting controls, and how should the sample report given in section 642 be modified to include those representations?

.19 *Interpretation*—The GAO’s standards state that they incorporate generally accepted auditing standards, and they make reference to section 320, “The Auditor’s Study and Evaluation of Internal Control,” and to section 642 as giving applicable guidance. Auditing literature does not give a comprehensive list of internal accounting controls applicable to all entities. Nevertheless, section 320.03 recognizes the need to clearly identify the elements of an entity’s total management information system, which includes information required for financial and other operating purposes, that are comprehended in internal accounting control. Section 320.19 states that “transactions

¹ The Yellow Book states on page 29 that the requirement for a report “does not require any additional audit effort other than that required as part of a normal financial and compliance audit . . .”

are the basic components of business operations and, therefore, are the primary subject matter of internal control." "Transaction" is defined as the entire cycle of steps necessary to complete the exchange of assets or services with parties outside the entity or the transfer or use of assets or services within it. The definition of accounting control given in section 320.27 is expressed in relation to the functions involved in the authorization, execution and recording of *transactions* and maintenance of accountability for assets. [Reference numbers 320.03, 320.19, 320.27, formerly 320.04, 320.20, 320.28, respectively, changed by the issuance of Statement on Auditing Standards No. 48.]

.20 Thus, section 642.20 states, with respect to a study and evaluation of an internal accounting control system made for the purpose of expressing an opinion on it, that "the accountant should identify the classes of transactions processed and the related assets and, for each significant class, identify the flow of transactions from authorization through execution and recording of transactions and the accountability for the resulting assets." The GAO standards also recognize this approach for the GAO's reporting purposes by stating that the requirement to identify the entity's significant internal accounting controls may be satisfied by identifying significant classes of transactions and related assets. Authoritative and other auditing literature recognizes that transactions may be grouped in a variety of ways and it gives examples of some possible ways.

.21 Section 642.20 states that groupings may be made on the basis of cycles of business activity or business functions. Business activity can be categorized by balance sheet accounts, accounting applications or significant transaction cycles. For example, classification by accounting system application could include cash receipts and disbursements, program receipts from the federal government, billings and receivables, purchasing, receiving and accounts payable, property and equipment, payroll and indirect costs. Classification by transaction cycles could include the financing or treasury cycle, revenue, production, purchasing or disbursement, and external reporting cycles. With respect to controls of federal agencies, departments and programs, for example, four cycles could be identified—disbursements, receipts, production and time cycles—the first three of which represent categories of federal government transactions that occur daily and the last representing other federal government events that occur periodically.

.22 Several variations are possible in the classification. An entity might classify its transactions into fewer or more than the four cycles mentioned in the preceding paragraph. For example, the financing or treasury cycle might be classified as separate investments and debt cycles. For federal agencies, departments and programs,

the disbursements cycle could be subdivided into, among others, grants, loans, entitlements, payroll, purchasing, property and equipment; the receipts cycle could include taxes, duties, fines and licenses, sales of goods and services and cash receipts, and the time cycle could include inventories, financial reports and doubtful accounts receivable. An entity might make its classifications on an entity-wide basis or on a departmental basis at the local operating units.

.23 Section 320.76 notes that classification generally should be broad, for example, cash disbursements rather than specific types of disbursements, although the section points out that there may be circumstances when a more narrow distinction may be appropriate because controls differ for certain transactions within a class. [Reference changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

.24 For reporting purposes, the sample auditor's report, given in section 642.49, on a study and evaluation made as part of the audit that is not sufficient for expressing an opinion on the system taken as a whole should be modified to include the identification of the entity's significant accounting controls and those controls identified that were and were not evaluated. An example of such a report follows.

"We have examined the financial statements of (name of entity) for the year ended June 30, 19X1, and have issued our report thereon dated August 23, 19X1. As part of our examination, we made a study and evaluation of the system of internal accounting control of (name of entity) to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards and the standards for financial and compliance audits contained in the U. S. General Accounting Office 'Standards for Audit of Governmental Organizations, Programs, Activities and Functions.' For the purpose of this report, we have classified the significant internal accounting controls in the following categories (identify control categories).² Our study included all of the control categories listed above except that we did not evaluate the accounting controls over (identify any category not evaluated) because (state reasons for excluding any category from the evaluation). The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the entity's financial statements. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting control taken as a whole or on any of the categories of controls identified above.

"The management of (name of entity) is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of

² Given below are examples of three different ways in which controls might be classified. The auditor should modify these examples or use other classifications as appropriate for the particular circumstances on which he is reporting.

1. *Cycles of the Entity's Activity*

- ☐ Treasury or financing
- ☐ Revenue/receipts
- ☐ Purchases/disbursements
- ☐ External financial reporting

2. *Financial Statement Captions*

- ☐ Cash and cash equivalents
- ☐ Receivables
- ☐ Inventory
- ☐ Property and equipment
- ☐ Payables and accrued liabilities
- ☐ Debt
- ☐ Fund balance

3. *Accounting Applications*

- ☐ Billings
- ☐ Receivables
- ☐ Cash receipts
- ☐ Purchasing and receiving
- ☐ Accounts payable
- ☐ Cash disbursements
- ☐ Payroll
- ☐ Inventory control
- ☐ Property and equipment
- ☐ General ledger

control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

"Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of (name of entity) taken as a whole or on any of the categories of controls identified in the first paragraph. However, our study and evaluation disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements of (name of entity) may occur and not be detected within a timely period.³ (A description of the material weaknesses that have come to the auditor's attention would follow.)⁴

"These conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in our examination of the 19X1 financial statements, and this report does not affect our report on the financial statements dated August 23, 19X1.

"This report is intended solely for the use of management and (name of regulatory agency or other third party) and should not be used for any other purpose."⁵

The Yellow Book, page 30, states that

³ If the study and evaluation discloses no material weaknesses, this sentence would state, "However, our study and evaluation disclosed no condition that we believed to be a material weakness," and the following paragraph of this report that begins, "These conditions . . ." would be omitted.

⁴ All material weaknesses that have come to the auditor's attention during the audit would be described, whether or not they relate to a category of controls that was excluded from the study and evaluation. Section 323, "Required Communication of Material Weaknesses in Internal Accounting Control," paragraph .03 notes that the auditor may become aware of material weaknesses through the preliminary review of the system or by performing substantive tests of account balances.

⁵ Section 642.48, footnote 7, states that this form of reporting is appropriate even though by law or regulation the accountant's report may be made a matter of public record. See the auditing interpretation entitled "Restricted Purpose Report Required by Law to Be Made Available to the Public," [section 9642.37—.38] dated December 1983, for additional guidance.

"There are a number of reasons why a study and evaluation of internal accounting control may not be made. They include:

(1) The entity is so small that it is not feasible to have an adequate internal control system.

(2) The auditor may conclude that the audit can be performed more efficiently by expanding substantive audit tests, thus placing very little reliance on the internal control system.⁶

(3) The existing internal control system may contain so many weaknesses that the auditor has no choice but to rely on substantive testing, thus virtually ignoring the internal control system."

.25 The Yellow Book, page 30, also states that if a study and evaluation is not made, ". . . the auditors must state in their report why a study was not made."⁷

[Issue Date: April 1, 1982; modified: December, 1983.]

8. Form of Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit

.26 *Question*—Section 642, *Reporting on Internal Accounting Control*, paragraph .49, illustrates an auditor's report on internal accounting control that is appropriate when he is engaged to report based solely on a study and evaluation of internal accounting control made as a part of an audit of financial statements and that study is not sufficient for expressing an opinion on the system taken as a whole. Section 642.50 indicates how the auditor should modify that report if his study and evaluation discloses material weaknesses. May the auditor modify the wording of those illustrations as he considers appropriate in light of the circumstances of each engagement?

.27 *Interpretation*—The auditor may modify the wording of the illustrative report on internal accounting control based solely on a study and evaluation made as part of an audit of financial statements provided it meets the requirements of section 642.48 and 642.50, which are:

⁶ Section 320.62 states that the auditor's conclusion that it is more efficient not to test compliance with controls to justify reliance on them in making substantive tests may result from consideration of the nature and amount of the transactions or balances involved, the data processing methods being used, and the auditing procedures that can be applied in making substantive tests. [Reference changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

⁷ For reporting guidance when no significant categories are studied and evaluated beyond the preliminary review phase, see the auditing interpretation entitled "Report Required by U. S. General Accounting Office Based on a Financial and Compliance Audit When a Study and Evaluation Does Not Extend Beyond the Preliminary Review Phase," [section 9642.35—.36] dated December, 1983.

- ☐ The report indicates that it is intended solely for management, a specified regulatory agency, or other specified third party.⁸
- ☐ The report describes the limited purpose of the study and evaluation.
- ☐ The report disclaims an opinion on the system of internal accounting control taken as a whole.
- ☐ If the study and evaluation discloses material weaknesses, the report describes the weaknesses and indicates that they were considered in determining the audit tests to be applied in the examination of the financial statements.

.28 The following is an example of a report on internal accounting control based solely on a study and evaluation made as a part of an audit that meets the minimum requirements of section 642.48:

"To the Board of Directors of XYZ Company

"We have examined the financial statements of XYZ Company for the year ended December 31, 19X1, and have issued our report thereon dated February 23, 19X2. As part of our examination, we made a study and evaluation of the Company's system of internal accounting control to the extent we considered necessary solely to determine the nature, timing, and extent of our auditing procedures. Accordingly, we do not express an opinion on the system of internal accounting control taken as a whole. However, during our examination, we did not become aware of any conditions that we believe to be a material weakness.

"This report is intended solely for the use of management (or specified regulatory agency or other specified third party)."

.29 If the auditor's study and evaluation or other aspects of his audit disclose material weaknesses, the last sentence of the first paragraph of the report example in the preceding paragraph should be modified as follows to comply with the requirement of section 642.50:

"However, our examination disclosed the following conditions that we believe to be material weaknesses.⁹ (A description of the material weaknesses that have come to the auditor's attention would follow.)¹⁰ These conditions were considered in determining the nature,

⁸Section 642.48, footnote 7, indicates that distribution of the report should be restricted to management or a specified regulatory agency or third party even though by law or regulation the report may be made a matter of public record.

⁹Alternatively, this sentence may state "However, our examination disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements of XYZ Company may occur and not be detected within a timely period."

¹⁰If management believes it is not practicable to correct the weaknesses, section 323.09 provides that the auditor may refer to the circumstances and summarize the weaknesses; a detailed communication of the circumstances and the related weaknesses is not required.

timing, and extent of the audit tests to be applied in our examination of the 19X1 financial statements, and this report does not affect our report on those financial statements dated February 23, 19X2."

.30 In deciding on the wording of a report on internal accounting control based solely on a study and evaluation made as a part of an audit, the auditor should consider, among other factors, the intended distribution of the report, for example, whether distribution of the report will be limited solely to management or whether the report also will be distributed to a specified regulatory agency and will be made a matter of public record. In the latter case, the auditor may consider it desirable to include a description of the objectives and inherent limitations of internal accounting control and management's responsibility for maintaining the system as illustrated in section 642.49.

.31 *Question*—Section 642.53 states that "suggestions or other comments concerning specific aspects of internal accounting control and various other matters" may be submitted to management "by letters, memoranda, and other less formal means." When the auditor submits such comments in writing, may he use such less formal means that do not include the items required by section 642.48 to express assurance on the entity's system of internal accounting control based solely on a study and evaluation made as a part of an audit of financial statements?

.32 *Interpretation*—No. If an auditor expresses written assurance on an entity's system of internal accounting control based solely on a study and evaluation made as part of an audit of financial statements (that is, if an auditor indicates in a written report that his study and evaluation did not disclose any material weaknesses in internal accounting control or indicates that his study and evaluation did not disclose material weaknesses other than those noted), that assurance should be expressed in a report that conforms to the requirements of section 642.48.

[Issue Date: December, 1983.]

9. Reporting on Internal Accounting Control Based Solely on an Audit When a Minimum Study and Evaluation Is Made

.33 *Question*—Section 320.53 (as amended by Statement on Auditing Standards No. 43), states that the minimum study and evaluation of internal accounting control that is required as a part of an examination of financial statements if an auditor does not rely on the entity's internal accounting control procedures to restrict his substantive tests may be limited to obtaining an understanding of the control environment and the flow of transactions through the accounting system. Should the illustrative report in section 642.49—.50 be

modified if an auditor becomes aware of material weaknesses in internal accounting control during his examination, but has only made the minimum study and evaluation required by section 320.53? [Reference number 320.53, formerly 320.52, changed by the issuance of Statement on Auditing Standards No. 48.]

.34 Interpretation—When an auditor only performs a preliminary review of internal accounting control as described in section 320.53 (as amended), both the report illustrated in section 642.49—.50 and the report illustrated in the interpretation entitled “Form of Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit” [section 9642.26—.32] are acceptable and need not be modified. Alternatively, an auditor may issue a report that more fully describes the limited nature of his study and evaluation provided the requirements of section 642.48 and 642.50 are met. For example, the auditor may replace the second sentence of the report illustrated in the interpretation entitled “Form of Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit” [section 9642.26—.32] with the following description of the nature of a preliminary review of internal accounting control:

“Solely to assist us in planning and performing our examination, we made a study and evaluation of the Company’s system of internal accounting control. That study and evaluation was limited to a preliminary review of the system to obtain an understanding of the control environment and the flow of transactions through the accounting system.” [Reference number 320.53, formerly 320.52, changed by the issuance of Statement on Auditing Standards No. 48.]

[Issue Date: December, 1983.]

10. Report Required by U. S. General Accounting Office Based on a Financial and Compliance Audit When a Study and Evaluation Does Not Extend Beyond the Preliminary Review Phase

.35 Question—The auditing interpretation entitled “Report Required by U. S. General Accounting Office” [section 9642.18—.25] (GAO) presents an example of a report on the study and evaluation of internal accounting control made as part of a financial and compliance audit when one or more significant categories of internal accounting control have been studied and evaluated. The GAO’s *Standards For Audit of Governmental Organizations, Programs, Activities, and Functions*, 1981 revision (The Yellow Book), page 30 states, “There are a number of reasons why a study and evaluation of internal accounting control may not be made. . . . However, the auditors

must describe in their report why a study was not made.”¹¹ However, Statement on Auditing Standards No. 43, *Omnibus Statement on Auditing Standards*, paragraph 2, clarifies the minimum study and evaluation of the system of internal accounting control contemplated by the second standard of fieldwork, stating that the review phase may be limited to obtaining an understanding of the control environment and the flow of transactions (that is, the preliminary review phase). How should the report example in the auditing interpretation referred to above be modified when the auditor has not made a study and evaluation of any significant category of internal accounting controls beyond the preliminary review phase?¹²

.36 Interpretation—A report such as the following should be used.

“We have examined the financial statements of (name of entity) for the year ended June 30, 19X1, and have issued our report thereon dated August 23, 19X1.

“Our examination was made in accordance with generally accepted auditing standards and the standards for financial and compliance audits contained in the U. S. General Accounting Office *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*. Solely to assist us in planning and performing our examination, we made a study and evaluation of the internal accounting controls of (name of entity). That study and evaluation was limited to a preliminary review of the system to obtain an understanding of the control environment and the flow of transactions through the accounting system. Because (state reason), our study and evaluation

¹¹ The Yellow Book, page 30, states that the reasons why a study and evaluation may not be made include the following:

“(1) The entity is so small that it is not feasible to have an adequate internal control system.

(2) The auditor may conclude that the audit can be performed more efficiently by expanding substantive audit tests, thus placing very little reliance on the internal control system.*

(3) The existing internal control system may contain so many weaknesses that the auditor has no choice but to rely on substantive testing, thus virtually ignoring the internal control system.”

* Section 320.54, as amended, states that the auditor’s conclusion that it is more efficient not to test compliance with controls to justify reliance on them in making substantive tests may result from consideration of the nature or amount of the transactions or balances involved, the data processing methods being used, and the auditing procedures that can be applied in making substantive tests. [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

¹² The auditing interpretation dated April, 1982, entitled “Report Required by U. S. General Accounting Office,” footnote 7 [section 9642.24], is amended to state:

“For reporting guidance when no significant categories are studied and evaluated beyond the preliminary review phase, see the auditing interpretation entitled ‘Report Required by U. S. General Accounting Office Based on a Financial and Compliance Audit When a Study and Evaluation Does Not Extend Beyond the Preliminary Review Phase,’ dated December, 1983.”

of the internal accounting controls did not extend beyond this preliminary review phase. Accordingly, we do not express an opinion on the system of internal accounting control taken as a whole.¹³ Also, our examination, made in accordance with the standards mentioned above, would not necessarily disclose material weaknesses in the system of internal accounting control. However, our examination disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements of (name of entity) may occur and not be detected within a timely period (a description of the material weaknesses that have come to the auditor's attention would follow).¹⁴

"These conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in our examination of the 19X1 financial statements, and this report does not affect our report on those financial statements dated August 23, 19X1

"This report is intended solely for the use of management and (name of regulatory agency or other third party) and should not be used for any other purpose."¹⁵

[Issue Date: December, 1983.]

11. Restricted Purpose Report Required by Law to Be Made Available to the Public

.37 *Question*—The United States General Accounting Office *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*, 1981 revision, requires a report on the study and evaluation of internal accounting control made as part of a

¹³ Even the completion of a study and evaluation made as part of a financial and compliance audit of an entity's financial statements generally is not sufficient for expressing an opinion on the system of internal accounting control. See section 642.10.

¹⁴ If the auditor does not become aware of any material weaknesses, this sentence would state, "However, during our examination, we did not become aware of any conditions that we believe to be a material weakness," and the following paragraph of this report that begins, "These conditions . . ." would be omitted.

¹⁵ Section 642.48, footnote 7, states that this form of reporting is appropriate even though by law or regulation the accountant's report may be made a matter of public record. See the auditing interpretation entitled "Restricted Purpose Report Required by Law to Be Made Available to the Public," [section 9642.37—.38] dated December, 1983, for additional guidance.

financial and compliance audit, and it makes reference to the report example presented in section 642, *Reporting on Internal Accounting Control*, paragraph .49.¹⁸ Sometimes auditors performing such financial and compliance audits are required by law to address their reports to legislative bodies and the public or to make the report a matter of public record. However, the last paragraph of the report given in section 642.49, states that the report is "intended solely for the use of management (or specified regulatory agency or other specified third party) and should not be used for any other purpose." May that statement be omitted or modified in reports issued when there are the statutory reporting requirements described above?

.38 Interpretation—The statement may not be omitted but it may be modified. Section 642, paragraph .49, states that the report is illustrative; it may be modified as long as the requirements of paragraph .48 are met. Paragraph .48 states that the report should indicate that it is intended solely for management, a specified regulatory agency or other third party, and footnote 7 to that paragraph states that the indicated form of reporting is appropriate, even though by law or regulation the report might be made a matter of public record. Thus, the report may be worded in such a way as to indicate that although the report is intended for a limited purpose, it is a matter of public record. Given below is an example of an appropriate modification of the last paragraph of the report illustrated in section 642.49.

"This report is intended solely for the use of management and (specify legislative or regulatory body). This restriction is not intended to limit the distribution of this report which, upon acceptance by the (specify legislative or regulatory body), is a matter of public record."

[Issue Date: December, 1983.]

[12.] [This interpretation has not been superseded by AU Section 325, *The Communication of Internal Control Related Matters as Noted in an Audit*. See section 9642 under "Auditing Interpretations".]

➡ The next page is 2251. ⬅

¹⁸ See the auditing interpretation entitled *Report Required by U. S. General Accounting Office* [section 9642.18—25], April 1982, for guidance on the form of report when a study and evaluation is made. That interpretation is amended by adding the following sentence to the end of footnote five:

"See the auditing interpretation entitled *Restricted Purpose Report Required by Law to Be Made Available to the Public* [section 9642.37—38], dated December 1983, for additional guidance."

Also, see the auditing interpretation entitled *Report Required by U. S. General Accounting Office Based on a Financial and Compliance Audit When a Study and Evaluation Does Not Extend Beyond the Preliminary Review Phase* [section 9642.35—36], dated December 1983, for reporting guidance when controls are not studied and evaluated beyond the preliminary review phase.

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